



# Fiscal Focus

Comptroller Loleta A. Didrickson

September 1998

State of Illinois

## COVER STORY: What is Privatization?



*“It is better for the public to procure at the market whatever the market can supply; because there it is by competition kept up in its quality, and reduced to its minimum price.”*

**Thomas Jefferson,  
1808**



While many people may assume that privatization is a recent phenomenon or management fad in the United States, it has in fact, been an important method of delivering government services since the early days of our Republic. Public officials in Thomas Jefferson's time, as well as now, are faced with the same concerns: providing essential services in a cost effective manner. Privatization can help public managers achieve that goal.

Privatization stimulates competition; and, competition stimulates productivity. Public officials from around the world are increasingly turning to privatization as a method of providing services to the public. A variety of financial and political upheavals have given governments



**The past 20 years have brought enormous changes in the structure and behavior of governments worldwide.**

Public officials have moved aggressively to downsize government by selling off assets to the private sector and contracting with private firms for more efficient operations and management of public services. Officials continue to adapt innovative techniques such as privatization to their local needs, and, in



## Fiscal Focus

*Fiscal Focus* is one of the ways the Comptroller's Office strives to assist taxpayers and the people of Illinois. This monthly report is designed to provide fiscal information of general interest and in compliance with state statutes.

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Web Address: <http://www.comptroller.state.il.us>

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Printed by the Authority of the State of Illinois 9/98 5800 Job 32370

Printed with Soyoil Based Ink  
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the process, create new, innovative strategies to provide quality services at the lowest possible cost.

Privatization has evolved from an ideological assault on the public sector in the 1980s to a kinder, gentler method of service provision that stresses competition between the public and private sectors. Through competitive contracting, the best possible services are provided at the lowest cost. Whether the provider is public or private, the taxpayer wins in the end.

The shift from privatization to competitive government has its best examples in cities across the United States. While Phoenix began the concept of allowing public employees to bid for contracts in the late 1970s, Indianapolis has perfected the system during the 1990s. Under Mayor Stephen Goldsmith, unionized public employees win a majority of contracts bid and have helped to save Indianapolis taxpayers hundreds of millions of dollars. In Connecticut the Governor, who is waiting on Legislative approval, has promoted privatizing data processing services and health services - all which is estimated to save the state \$75 million a year.

In Illinois, governments from Chicago to Cairo are changing the way they provide services. Chicago under Mayor Daley has privatized many functions, including janitorial services, towing and meter enforcement, and saved taxpayer dollars. At the other end of the state, three counties (Alexander, Pulaski and Union) are forming a unique partnership with a private firm to build a regional jail facility. At both ends of the state, urban and rural, officials are challenging the old way of doing things and succeeding at changing the way they do business.

What changes in government will occur in the year 2000 and beyond?

Already, changes in IRS regulations have produced many long-term water and wastewater privatizations at the local level. Local governments are able to receive savings up front in a concession fee for infrastructure improvements. They also benefit from continuity and stability in operations. Look for more local governments, especially smaller ones, to adopt long-term contracts in these service areas.

In another example of local innovation, governments will be teaming up with each other and private firms to combine the practices of privatization and intergovernmental agreements. These arrangements offer cost savings, avoidance of duplication and enhancement of

services. In addition to the regional jail facility in southern Illinois mentioned previously, three cities in northern Illinois (Batavia, Geneva and St. Charles) combined with a private firm to provide ambulance service, saving approximately \$300,000 per year.

Internally, government employees will require new and different skills than they traditionally have possessed. A successful privatization initiative, for example, requires enhanced technical skills on the part of public officials and employees that are quite different from traditional public administration approaches.

With more contracting with other governments and private firms, many government officials will need to be able to monitor contracts. This will involve more legal and analytical skills to ensure contractor compliance and performance. Government attorneys and consultants will have an enhanced role to insure proper monitoring and bidding procedures are followed.

Officials will also need to be able to accurately determine the true costs of providing services. Some states and local governments have developed models for proper cost accounting including Activity-Based Costing (ABC). These models are vital for officials to fairly compare public and private costs of providing services.

Another new skill necessary for 21st century government employees will be to accurately measure performance. Benchmarking and other performance measurement tools can help governments determine the "bang for the buck" and increase accountability to taxpayers. In Illinois, the Comptroller's Office has undertaken the Service Efforts and Accomplishments (SEA) to measure performance at the state level.

In summary, government employees' tasks in the future will not be directly providing services as much as ensuring that those services are being provided. Additional training and educational programs will be needed to prepare the public workforce for these challenges.

Innovative officials from both public and private sectors are continuing to develop creative strategies to help overcome obstacles to privatization and other alternate management techniques. Through careful planning and creative thinking, officials are making privatization a viable option for governments across the world.

*Loleta Didrickson*



# P

## rivatization and Cost Savings

Talk of privatization instinctively raises questions of cost savings and efficiencies. There are many reasons for privatizing government services (greater flexibility, more

innovation, higher quality, etc.), but cost control or cost savings still appears to be the primary objective for privatization or managed competition. In spite of this oft-stated purpose, though, there may be less here than meets the eye.

In a recent survey of states, the Council of State Governments (CSG) concluded, "While *few officials are monitoring cost savings closely*, many view privatization as a practical, cost-saving management tool" (emphasis added). Almost half of the respondents in the CSG survey cited cost savings as the primary reason for an increase in privatization (no other purpose was even close), yet there appears to be a divergence between purpose and action in this instance. There are reasons for this seeming inconsistency, and this article will explore the role of cost analysis in privatization and managed competition.

### Why Cost Analysis Is So Important...

Critics of privatization frequently claim that it does not save government and taxpayer money. Setting aside the universally accepted problems with broad generalizations such as this, are they right? The simple answer is that without sound cost analysis and information, it's impossible to tell. It may be of scant comfort to claim that the opponents of privatization have no basis for such criticisms if elected officials and government managers can't prove their case either.

If privatization is justified solely on the grounds of cost savings, then the in-house costs avoided must be greater than the new contractor costs or there would be no justification for privatizing. The inability to demonstrate cost savings leaves officials who claim this as their purpose open to critics opposed to privatization. Such claims have to be supported by factual, quantifiable, verifiable information, or the very concepts of economy, efficiency

or cost-benefit themselves become meaningless.

Put simply, it's impossible to determine efficiency, cost-effectiveness, or cost-benefit without adequate and accurate cost information. And it's not just general cost information that's required, but the capability of relating costs to the outputs and outcomes of the program or service involved. To say that a highway painting operation costs \$650,000 in total, for example, is one thing. It's another matter to know that it costs \$131.89 for every mile of center line striping. This kind of information and analysis is essential in determining cost savings, whether through privatization or in-house-delivery of services.

As suggested above, however, this kind of analysis may not yet be the reality. In the CSG survey three out of five agency respondents (419 total) only estimated their cost savings, and 62.3 percent of those reporting saved less than 5 percent through privatization. Similarly, in a recent study of state and local governments, the U. S. General Accounting Office (GAO) indicated that four of the six governments it studied made "best estimates" of service or function costs "because obtaining complete

cost and performance data by activity from their accounting systems was difficult."

The classic argument is that it's extremely difficult to measure government performance. Throw in the inability to capture true cost information and it becomes impossible to say anything meaningful. Is it any wonder that taxpayers are so apathetic, skeptical, or even hostile toward government programs and services? Running government more like a business does not have to mean making a profit, which is not government's primary goal. It does mean operating in a more business-like manner, which requires solid cost and performance information as the basis for 'business' decisions.

### How And Where Cost Analysis Is Used...

There is reasonable agreement that cost information and analysis is both useful and necessary in four



areas involving privatization or managed competition: competitive analysis, pre-award, post-award, and other uses.

- **Competitive Analysis.** There would be no point in even pursuing privatization or managed competition unless there is some reason to believe there will be cost savings or efficiencies, if that's the primary goal. After all, why privatize, if in-house delivery of services is already cheaper? Experienced governments use preliminary cost information and analysis in reaching these conclusions and identifying candidates for privatization. This means some analysis of in-house costs and estimates of private or market-based costs *prior to* a decision to privatize. A number of governments (e.g., federal, Texas, Cincinnati) have adopted a policy requiring projected cost savings of 10 percent or more if privatization is to be worth the effort.

- **Pre-Award Phase.** Once a decision has been made to pursue privatization or managed competition, the next step is the request-for-proposals (RFP). The RFP specifies the work requirements, outputs and outcomes expected, performance standards to be achieved, and allowable costs — making sure you ask for what you want, in the words of one author. Asking for what you want implies knowing what you want, and no one could prepare a realistic bid without such information. Following the RFP, proposals submitted by the various bidders are evaluated to determine cost competitiveness.

- **Post-Award Phase.** After the decision to award delivery of services, the government retains the responsibility to monitor compliance with the terms of a privatization agreement and to evaluate the contractor's performance at the end of the agreement — making sure you get what you ask for, in the words of our author above. Performance measures and cost information are used to determine overcharges or inappropriate costs, poor performance, cost savings or efficiencies, and whether cost savings are at the expense of the quantity or quality of services. Officials from most governments in the GAO study indicated this was the weakest part of their privatization processes.

#### • Other Uses of Cost Information.

Cost information is also essential for other purposes directly or indirectly related to privatization decisions. Decision-makers must know the real costs of services if they plan to recover some or all of those costs through user fees. Identifying and reducing non-essential or inflated costs is only possible with detailed cost information. Some governments use cost analysis information in conjunction with other management tools such as business process re-engineering, service redesign, or process improvement. A thorough



understanding of costs even opens the possibility of using some of the expected cost savings as financial incentives in performance-based contracts designed to improve service quality or innovation.

#### Why Cost Analysis Is So Difficult..

Cost analysis is one of the biggest challenges facing government today. The CSG survey reported that, even though comparison of in-house and private-sector costs of performing services is central to the privatization decision, states are struggling with this difficult task. In 1993 Illinois' Private Enterprise Review and Advisory Board, a group established by gubernatorial executive order to examine

privatization of government services, recognized that "measuring cost savings from privatization is a difficult and problematic process" and "opted not to include speculative cost savings figures" in its report.

Cost analysis is a complex process involving some rigor and discipline. It requires a methodology, but also involves subjective judgments. One practitioner describes it as more art than science. The process is all the more difficult because of three contributing factors: 1) determining what costs to include, 2) the nature of governmental information systems, and 3) the lack of a standardized methodology.

#### • Determination of Costs to Include.

Determining the direct costs of a service would be challenging enough. A highway maintenance unit involved in both road and bridge repairs and road markings, for example, would have to be able to allocate its costs between the two different functions, not to mention between different activities within the same function. There would also likely be the direct costs of another unit performing work for the highway maintenance

unit (e.g., information systems processing). However, there are several other cost analysis challenges which must be addressed.

Many costs cannot be directly assigned to a function. These typically include a portion of the costs of higher level management personnel, rent and utilities, or central processing functions such as accounting, personnel, etc. Known as indirect overhead costs, they must be allocated on some basis to arrive at the real costs of the function.

Privatization may involve still other costs which must be included such as contract administration (procurement, negotiation, award, modifications, dispute resolution, etc.); one-



time conversion costs; costs arising from the displacement of government employees (unemployment compensation, job re-training, etc.); and contract monitoring and evaluation. Experts estimate that contract administration costs alone range from between 0 and 25 percent of contractor costs, with five to ten percent probably closer to the reality.

Cost analysis is central to the fairness of the game. The failure to include a cost such as contract administration and monitoring, for example, underestimates the true cost of the contract. When contractor costs are underestimated, government employees complain. On the other hand, one major study suggests that in-house public service costs may be underestimated by as much as 30 percent. When in-house costs are underestimated, businesses complain. If overhead cannot be determined, it cannot be reduced. And if overhead cannot be reduced, there will likely be no cost savings or contractor costs may even be higher.

- **The Nature of Governmental Information Systems.**

Most governmental budgeting and accounting systems, using an object-of-expenditure approach as many do, are not structured to generate the required information. Unless employees keep time logs by activity, for example, the unit's total costs for labor, travel, materials, etc. may be known, but not necessarily the costs of discrete programs, services, or activities within that unit. Short of re-designing the budgeting and accounting systems, in most instances this means expenditure information must be re-cast or *ad hoc* systems and procedures put in place to capture detailed cost information.

Closely related is the issue of performance measurement. Many government programs have difficulty defining what they are trying to accomplish, making it all but impossible to define and measure acceptable performance. Cost analysis

couples the resources consumed with the performance outputs and outcomes. To illustrate, efficiency is a measure of the resources consumed in producing a given result, enabling government managers to understand and compare with some confidence the differences between cost proposals of \$5.13 and \$3.73 per square foot for maintenance services. This requires not only a definition of performance in terms of quantity, quality, timeliness, or satisfaction with services, but also the means to collect, organize, and report such measures. Many gov-



ernments lack this capacity because of the lack of attention to either the definition of performance or the requisite management information systems.

- **Lack of a Standardized Methodology.** Every substantive study of privatization has recommended development and implementation of a standardized procedure for cost-benefit analysis and comparison of public and private sector costs. A standardized procedure establishes open, fair decision-rules and guidelines for cost analysis and comparisons, removing some of the difficulty and providing a sound framework for cost compar-

isons. Yet almost three-quarters of state respondents in the CSG survey said they do not use a standardized decision-making process to determine which activities to privatize.

**Some Possible Approaches...**

Whatever the difficulties, governments interested in privatization or managed competition will have to use some method to get a handle on costs. There are several possibilities.

- **Estimating Service Costs.**

The available evidence indicates

that most governments are still only estimating the costs of services. Doing cost analysis 'on the cheap,' however, can backfire. One state's reported cost savings from privatization were called into question by the state auditor because of an "inadequate cost analysis" before privatization, as well as a lack of data to support the claimed benefits following privatization. Additionally, the failure to determine the full and real costs, more likely when costs are only estimated, lends itself to complaints from businesses about government's unfair advantage in submitting supposedly competitive proposals.

- **OMB A-76 Process.**

The federal government has had a long-standing policy on the "performance of commercial activities."

The Office of Management and Budget's (OMB) Circular A-76 specifies that, whenever a commercial activity can be performed by either a commercial source or the government, a comparison of costs is required to determine who will do the work. In addition to defining what constitutes "commercial" activities, this Circular provides detailed guidance on conducting cost analysis and comparisons.

A-76 addresses in detail what costs are to be included and meets the test of a standardized methodology for cost comparisons. One example is the policy requires the use of a simple staffing formula in

*See COST SAVINGS, page 30*



## The State Procurement Process — Ripe for Privatization?



Procuring goods and services for the operation of state government in Illinois is big business! As the centralized purchasing agent for a large portion of state government, the Department of Central Management Services (CMS) had contracts on file for approximately 174,000 items with nearly \$300 million in equipment and commodities purchased through those contracts in fiscal year 1998.

For as long as officials with CMS can remember, centralized procurement has been the mode of operation for much of state government. However, while the general aspect of centralization in the acquisition of goods and services has not been changed, many of the guidelines have.

### Illinois' Procurement Code

Most recently, legislation was signed on February 6, 1998 which created The Illinois Procurement Code. The code placed procurement laws under one statute and repealed acts

such as the Illinois Purchasing, State Paper Purchasing, State Printing Contracts, and

other predecessor acts and applies to procurements for which vendors are first solicited on or after July 1, 1998. The Illinois Procurement Code applies specifically to agencies, universities, and boards and commissions subject to the jurisdiction of the Governor while Constitutional Officers are required to procure their goods and services in primarily the same manner and put in effect rules as restrictive as the code. Legislative and Judicial branches are completely exempt from the code. Constitutional Officers and the Legislative and Judicial Branches may still utilize CMS master contracts for their procurements, however they are not bound to utilize these contracts.

The establishment of new bid thresholds and the elimination of some exemptions to advertising and bidding requirements previously found in the State Purchasing Act are the major changes instituted as a result of the new Code. In addition, the code has effectively relegated more authority and control of the procurement process to the Department of Central Management Services.

Prior to 1992, state law required that most contracts for goods or services amounting to \$5,000 or more be awarded through competitive bidding. In 1992, the requirement to use competitive bidding was replaced with a requirement to use competitive selection procedures. Although competitive bidding may be one of the preferred selection procedures, it was no longer mandated. In addition, the 1992 changes also raised the threshold for using the competitive selection procedures to \$25,000. Under the new code, this threshold has been lowered to \$10,000 for most goods and services

and \$20,000 for professional and artistic services (which were previously exempt from bidding). The code also allows for an

increase in the threshold each July 1 in accordance with the Consumer Price Index.

Aside from eliminating the exemption for professional and artistic services, other exemptions eliminated include: personal service contracts with employment firms; original equipment (sole source) manufacturer maintenance/service contracts; electronic data processing and telecommunications equipment, software and services; duplicating machines and supplies; natural gas; lottery tickets; state police forensic science lab contracts; and nuclear safety contracts.

Other changes as a result of the new code include organizational changes and the requirement that bulletins for procurement opportunities be posted on the internet rather than in the Official State Newspaper. One

organizational change is in procurement authority. The code provides for four Chief Procurement Officers including the Executive Director of the Capital Development Board who oversees real property (vertical) construction, the Secretary of the Illinois Department of Transportation for road (horizontal) construction, a representative designated by the Governor for all procurements made by public institutions of higher education, and the Director of CMS for all other procurements within jurisdiction of the governor.

Also created by the Illinois Procurement Code is a five member policy board consisting of appointees by each of the four legislative leaders and an appointee of the Governor who shall serve as chairperson. The Board serves primarily an advisory role and is responsible for reviewing, comment-

For a variety of reasons, prices on CMS master contracts are not always the best deal in town. Certainly geography and transportation costs play a role in price fluctuations along with supply and demand.

In a market comparison conducted in Springfield and Chicago comparing the best available price on a selected group of commodities against CMS master contract prices, geography as a price variable was certainly evident. The best available price in Springfield was lower than the best available price in Chicago for all ten items. Prices for nine of the ten items compared were lower in Springfield than what CMS master contracts offered while only two of the ten items were less expensive in Chicago.

Whatever the prevailing reason for price fluctuations, purchasing flexibility which allows for savings to the state

The procurement card differs from a credit card because the bills are paid in full every cycle, and the charges are paid directly by the company or public sector entity. Certain limits can also be placed on procurement cards. These limits can include dollar amount per transaction, per day or per billing cycle. The procurement card authorization system prevents employees from exceeding these limits. In contrast, corporate credit cards usually have no limits. With a corporate credit card the charges are the responsibility of the employee and employee reimbursement is accomplished through a voucher.

The Illinois Office of the Comptroller is in the process of developing a procurement card pilot program for petty cash purchases.

Experiences in other States show that Illinois would realize many benefits from a procurement card program. The impact of a card on the procurement process would be 1) improved vendor relations and an increased vendor pool, 2) more convenient purchasing, and 3) savings in the processing of payments.

The State of California, Department of General Services Administration issued a report on their pilot program. They found that when using the State

Visa Procurement Card (Cal-Card), employees were able to achieve better prices that were, on average, 17% lower. In fact, California's new procurement contract with Office Max gives the State an additional two percent discount on purchases made with the Cal-Card. Thirty-five percent of employees participating in the pilot program reported that vendors who

See STATE PROCUREMENT, page 30



ing upon and recommending rules on issues dealing with procurement.

### Single Source Procurement vs. Alternative

While many things changed with the implementation of the Illinois Procurement Code, one aspect that remains the same is the fact that not all Illinois government entities procure in the same manner. As previously mentioned, those entities under the Governor's jurisdiction must procure their goods and services through CMS only. Constitutional Officers along with the Legislative and Judicial branches, however, may take advantage of the open-market for goods and services or at their option utilize CMS master contracts in an effort to meet the functional needs of their office.

Market Price Comparison for Selected Commodities

Item	CMS Master Contract Price	Best Price in Springfield	Best Price in Chicago
12 Digit, Printing, Desktop Adding Machine	\$ 48.95	\$ 24.99	\$ 39.99
3" x 5" Post-it-Note Pad	0.76	0.49	1.20
1 Dozen #2 Pencils with erasers	0.53	0.50	0.58
1 Dozen Ballpoint Pens with cap and clip	0.99	0.98	1.98
17" x 22" Desk Pad Calendar	2.48	1.99	4.49
4.6 oz. tube of Colgate Tartar Control Toothpaste	1.53	0.97	2.99
1 Gallon Auto Windshield Washer Fluid	1.06	0.78	1.10
12 Volt Auto Battery with min. 750 cold crank amps	70.21	57.96	64.99
1 Gallon Orange Automotive Antifreeze	6.54	5.97	7.79
18" x 25" roll of Aluminum Foil in Cutter Box	1.23	1.59	2.25

and it's taxpayers is optimal. As the market comparison clearly shows, the opportunity for savings exists. In addition to purchasing flexibility, new technology such as procurement cards, can improve the efficiency of the procurement process as well as saving taxpayer dollars.

### Procurement Cards

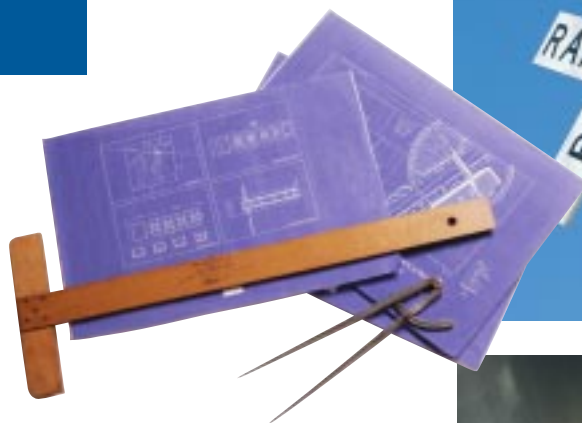
The procurement card allows purchases to be made without using purchase orders, petty cash or credit.





# I

## nfrastructure Privatization Key to Development and Competitiveness



As local governments in Illinois face a variety of financial challenges, many officials are looking to the private sector for solutions to upgrading their infrastructures. Privatization of infrastructure projects, such as roads, bridges, mass transit, water and wastewater systems, is important not just for local service delivery, but for stimulating economic development and making communities more competitive.

Governments are investing more on public projects related to infrastructure needs. According to government data, the value of local and state government structures increased from \$2.4 trillion in the late 1980s to \$3.1 trillion in 1995.<sup>1</sup> Those regions that are spending more on infrastructure are benefiting from higher job growth. In regions of the nation where infrastructure spending was higher than the national rate, job growth was better than average. According to the analysis, the east North Central region, including Illinois, had a job growth rate of 2.04 percent from 1991-95 compared with the national average of 2.00 percent.<sup>2</sup> The region's investment in infrastructure was also higher than the national average.



Private construction and operation of governmental infrastructure offers many opportunities for cost savings, efficiency and service enhancement. Local governments, facing aging infrastructures, reduced levels of intergovernmental assistance, and citizen opposition to tax increases, are increasingly looking to innovative solutions with the private sector. This article will focus on two important areas where privatization and public-private partnerships offer local officials an opportunity to upgrade their infrastructures: water and wastewater systems and mass transit.

### Water and Wastewater Systems

While financial pressures are driving many local governments to con-



sider privatization of water and wastewater services, recent rulings by the Internal Revenue Service (IRS) have created additional incentives for innovative public-private solutions. In response to the rapid pace of municipal privatization efforts, the IRS loosened restrictions under which tax-exempt bonds retain their exempt status in a public-private partnership. In addition, IRS regulations made possible longer-term contracts between private firms and governmental bodies. The net effect of the changes is to open more opportunities for privatization and public-private partnerships for water and wastewater services, an area where such innovative strategies are currently limited.

### Extent of privatization

Nationwide, the number of privately-operated water and wastewater systems increased from 941 to 1,200 in the last year, a 27.5 percent increase.<sup>3</sup> Still, the number of privatized systems is relatively small overall. For example, just 20 percent of water supply and two percent of wastewater systems are privately operated in the U.S. In contrast, privatization of these facilities is widespread in Europe, where nearly 70 percent of water and wastewater services are privately owned.

Currently, there is more private ownership of water facilities than wastewater plants in the U.S., although trends suggest more growth for wastewater privatization in the future. Most water systems are small and serve small populations. There are a small number of larger systems that serve a bigger population base. In fact, systems serving 3,300 or fewer customers



represent 87 percent of all water systems but serve only 11 percent of the population.<sup>4</sup> Those serving communities of more than 100,000 are only 0.5 percent of all water systems, but include approximately 44 percent of the total population served. Peoria (pop. 113,500) is one of the largest cities nationwide served by an investor-owned water system.

In Illinois, wastewater systems can be run by general purpose governments (mostly municipalities) and sanitary districts while water systems are



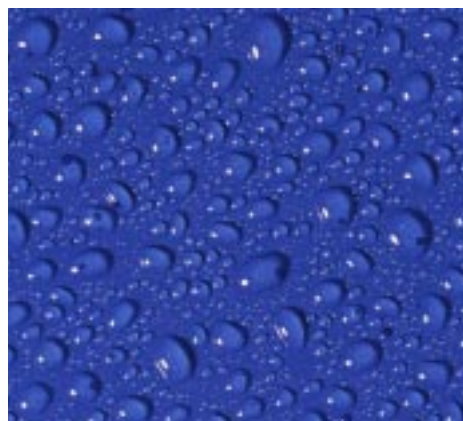
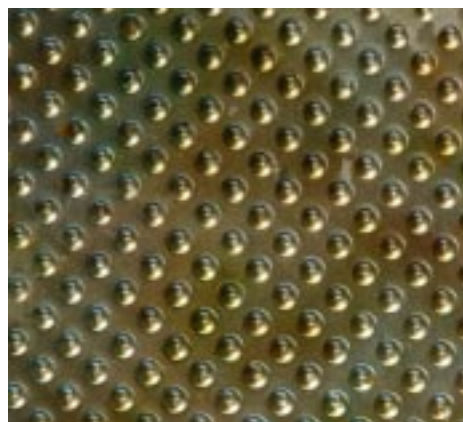
run mostly by municipalities, but also by water districts in rural areas. According to a survey of municipal governments conducted jointly by the Office of Comptroller Loleta Didrickson, the Illinois Municipal League and Illinois Institute for Rural Affairs, the amount of privatized management of water and wastewater facilities is limited. Statewide, 7.9 percent of municipalities contract for water treatment; 5.1 percent for water distribution; 6.5 percent for wastewater treatment, and 3.9 percent for wastewater collection.<sup>5</sup> Larger cities contract for these services slightly more often than smaller communities.

Cities of all sizes and from across the state reported satisfaction with privatization for these public works services. Among the communities in Illinois that have successfully contracted water and wastewater services are Pekin (pop. 33,000); Carol Stream (pop. 36,000); Lincoln (pop. 15,400); Edwardsville (pop. 18,900); Wood River (pop. 11,500); and, tiny Elizabeth (pop. 700). Monmouth (pop. 9,500) officials report savings of approxi-

mately \$100,000 per year due to contract management of its wastewater facility.

In response to a question concerning which services they were likely to contract for in the near future, local officials in Illinois indicated privatization of water and wastewater services will likely increase. Officials from larger cities are more likely to privatize water and wastewater services than those from small cities.

In fact, the most active market in the privatization industry nationwide is



wastewater treatment for several reasons. First, all local governments own wastewater treatment facilities as opposed to other utility functions such as electric power plants. Second, water and wastewater services are often the largest expenditure facing local governments, according to the U.S. Conference of Mayors.<sup>6</sup> Finally, the market for wastewater services is very competitive, with national, regional and local firms all vying for business opportunities. Recently, large cities such as Indianapolis, Seattle, New Orleans, and

Milwaukee have completed water or wastewater privatization agreements. Atlanta is currently moving towards privatizing operations of both its water and wastewater systems.

### Advantages of privatization

Privatization of water and wastewater services can offer a variety of benefits for local governments. In most instances, contracting results in cost savings which is a major reason officials decide to privatize in the first place. Cost savings can be attributed to several advantages the private sector has over public entities: economies of scale; efficiencies due to competition; specialization and technical expertise; and the lack of certain constraints, such as acquiring equipment and hiring personnel, that are present in the public sector. Case studies of wastewater privatization report construction and operational cost savings of between 20 to 50 percent.<sup>7</sup>

Another important advantage to private provision of services is performance enhancement and improved quality of services. Privatization often leads to the addition of new technologies and computerization of the treatment facilities which are more difficult for a public entity to achieve. Quality and performance upgrades allow many private firms to guarantee compliance with environmental regulations in their contractual agreements. In addition, private firms offer greater opportunities for training of personnel, with incentives offered for continuing educational and training programs.

### Growth factors

The number of contracts for wastewater operations in the U.S. has grown in recent years by 15 to 20 percent annually.<sup>8</sup> There are predictions that privatization will continue to grow from its current five percent share of the market to 35 percent of all treatment plants. Currently, industry sources estimate that privatization is under consideration in approximately 5,000 of the 16,000 wastewater facilities in the U.S.<sup>9</sup> The stakes are enormous since there are approximately \$30 billion of wastewater treatment facilities currently owned by local governments.<sup>10</sup>



There are a variety of reasons officials will be considering privatization of water and wastewater operations in the future. Many facilities were built with federal funds more than 20 years ago and are becoming obsolete due to federal environmental regulations. The U.S. Environmental Protection Agency (EPA) estimates at least \$100 billion will be required to finance new wastewater rules and regulations in the next decade, but funding levels provided by Congress will not be nearly enough to fund improvements.<sup>11</sup> New treatment technologies and capital improvements will be needed to meet more stringent requirements for clean drinking water under the Safe Drinking Water Act and sewer outflows under the Clean Water Act. Carthage (pop. 2,500), facing the threat of EPA sanctions for wastewater violations, contracted for wastewater services and met EPA guidelines ahead of schedule.

While federal funding assisted many local governments with construction of treatment plants under the Clean Water Act Amendments of 1972, federal funding sources have been drastically reduced in recent years. The state of Illinois provides loans for water and wastewater systems, but that provides little help for many cash-strapped local governments. Many of the systems, built more than 20 years ago, are aging and badly in need of repair. System upgrades are expensive due to technologies and capital required.

In addition, local governments face external and internal pressures on finances. Some counties have enacted tax caps that limit growth in property tax revenues. Other local revenue sources are limited for local governments, especially those that are not home-rule communities. Internal financial pressures include normal, day-to-day operating expenses such as equipment upgrades and rising personnel costs. Citizen opposition to tax and fee increases also hampers local officials' ability to deal with the problem of aging water and wastewater systems.

With rising operational costs, reduced levels of intergovernmental assistance, and pressures on local offi-

cial to avoid tax increases, privatization becomes an increasingly attractive option.

Recent changes in Internal Revenue Service (IRS) rules have made privatization agreements more feasible for local governments. The IRS ruled in 1997 that private firms can operate or own public facilities financed with tax-exempt bonds for up to 20 years and still maintain a tax-exempt status. Previously, contracts in these circumstances could not exceed five years.

Long-term contracts offer several advantages for local officials considering contracting for water and waste-



water services. Local governments can achieve greater savings from a longer-term agreement and can have greater stability and continuity in operations. In addition, savings generated over the life of the agreement can be requested up front for use in an expensive, capital-intensive project. This type of agreement was completed recently in Cranston, RI and Danbury, CT. Cranston, for example, entered into a long-term agreement and received savings up-front in a concession fee of \$48 million. Danbury received \$10 million, a portion of its total projected savings, early in the course of a 20-year agreement. In Illinois, Mount Vernon (pop. 17,000) entered into a 20-year design,

build, operate contract that helped the city meet EPA regulations ahead of schedule and led to enhanced economic development opportunities.

### Outlook

Privatization of water and wastewater services will continue to grow in the future due to numerous financial pressures facing local governments. As more communities achieve success with privatization, more governments will consider it as a viable, alternate service delivery method. Officials will not need to face a financial crisis as a reason to look into privatization. By contracting with a private firm, local officials are gaining capital upgrades, reduced operating costs, and a better infrastructure without dramatic increases in rates. Growth will continue in Illinois communities as successful examples are shared by officials from throughout the state. Innovative officials from both the public and private sectors will continue to develop creative partnerships to meet the needs of citizens in the future.

### Transportation - Private Sector Management of Transit

Public transit provides mobility for people without access to automobiles, especially the young, elderly and people with low incomes. Public transit's importance increases as metropolitan areas "sprawl" beyond the core city. Effective public transportation is further complicated by demographic changes that shift need from traditional "radiating systems" that largely served commuters to interconnected regional systems serving neo-urban centers surrounding the core city. Mass transit regional planning is challenged to create a borderless system of options to help reduce traffic congestion and air pollution. Most people, when thinking of transit in Illinois believe it is confined to Chicago and the Chicago suburbs.

Ecology issues are a major factor in establishing the importance of public transit. A global conservation movement calls for mass transportation as a means of reducing dependence on fossil fuels, which are both limited and hazardous to the environment.



As our cities' infrastructures and populations continue to age, efficient, high quality transit systems become ever more significant. Increasingly, it is becoming apparent that the public



monopoly over transportation has out lived its promise, and in some cases may be a barrier to the provision of effective and efficient service. Economics and service are foremost in setting privatization agendas in public transit.

### **Economic Dynamics**

Apart from any philosophic argument, it is obvious that a generation of exclusive public management of public transportation has resulted in a pattern of service cuts, fare increases and demands for increased subsidies from the taxpayer. The notion of providing greater and improved service has been replaced with a "rescue" mentality. Rather than growing the system, universal public management philosophy has been geared to the survival of a diminishing service. It is ironic that at the point of greatest potential demand (i.e. congestion, welfare to work, environmental concerns, etc.) the transportation systems have produced lessened services.

The approach of increasing fares on a decreasing ridership has launched a cycle of decline. Fare increases drive away riders. The American Public Transit Association (APTA) has esti-

mated that each 10 percent increase in fares reduces transit ridership by 3.6 percent in large cities. Since 1979, transit ridership has fallen by 14 percent.<sup>12</sup>

Like elsewhere in America, public management dominates Illinois transit. In Chicago, CTA fares and subsidies have continued to increase while ridership has declined by 39 percent. The CTA's loss in bus customers during this period now exceeds the entire population of St. Louis.<sup>13</sup>

### **Competitive Contracting Mass Transit**

A system of competitive contracting would replace the government monopoly provision of services. Private sector transit companies bid for the right to provide transit service, utilizing the free market to



provide efficient and effective service. Gains from competitive contracting can be used to increase service, and retard fare increases. The cycle of cost increases and service cuts can be ended.

Recurring concerns about competitive contracting include market served, service quality, and job security. Customer savings from competitive contracting can make it easier for the economically disadvantaged to obtain and hold employment and can increase mobility for everyone.

Profit motives of competitive contracting are actually an excellent guar-

antee to quality service. Failure to provide quality service is likely to result in contract termination.

Competitive contracting can be phased in on an attrition basis to guarantee jobs and compensation of existing employees. Public transit employees need not lose their jobs or suffer reductions in compensation. In addition, competitive contracting can actually provide more jobs and particularly more opportunity for entrepreneurial and minority business enterprises. For example, 25 percent of the private transit industry in the Chicago area is minority owned and operated. Minority set asides can assure that these businesses and their suppliers grow and expand under competitive contracting.<sup>14</sup>

### **The New Public Sector Management in Transit**

The new public sector management in transit utilizes free market solutions to provide government services in a more cost-efficient manner. At the forefront of this movement is the use of private sector transit agencies to supply mass transit services. Public transit agencies across the country, and indeed across the world, have been very successful in reducing costs and increasing the quality of services provided. The experience of cities around the world with private provision of transit services indicates that operating costs can be reduced and quality of service enhanced.

For example:

- Los Angeles contracted out bus service to private operators in a 60% reduction of the costs of providing service. Quality of service also has risen with the use of private contractors.
- In Colorado, state legislation required Denver to contract out 20 percent of its transit service to private operators. This has resulted in long-term savings of 31 percent.<sup>15</sup>
- San Diego contracted out 38 percent of its service with an average cost savings of 30 percent.<sup>16</sup>
- The city of Las Vegas contracts out its entire system. Costs per vehicle hour dropped by 33.3 percent.<sup>17</sup>
- New York City's private bus operators have a 29 percent lower cost per unit of service, provide 10 percent more service per employee and



have 31 percent fewer employees per bus than the public sector.

- Foothills Transit outside Los Angeles contracts out its entire system to private operators. Its ridership has risen by over 50 percent, it has added 57 percent more service, its operating costs have fallen by 31 percent and its fares are 37 percent lower.
- London, which operates the world's largest bus system, has privatized over half of its system. Services have expanded by 29 percent and operating costs have fallen by 30 percent.<sup>18</sup>
- Stockholm runs a 2,000-bus system with 900 rail cars. It contracts out two-thirds of its bus service and all rail service. Operating costs have fallen 17 percent while service has increased by 13 percent.<sup>19</sup>

### **Economic Patterns of Competitive Contracting**

The three general patterns of implementation are ad hoc, gradual and immediate. The "just do it" alternative often proves to be the most beneficial. Those that have converted to system-wide competitive contracting (New Zealand and Melbourne) have realized immediate cost savings. Farebox recovery ratios increase as transit service is provided more efficiently. This means that taxpayer subsidies buy more transit services per dollar. A one-percent increase in bus service yields .6 to .8 percent increases in ridership. This growth in ridership provides greater benefits for customers, taxpayers and the entire public transit service area.

Gradual conversion (periods of five years or less) produced reduced costs per mile by 15 percent or more in response to threat of competition (Perth, Adelaide, Brisbane and Copenhagen). Longer-term transitions (San Diego and London) have shown ripple-effect savings. Lastly, ad-hoc transition also produces ripple-effect savings, but often these savings diminish as no long-term conversion is intended and the benefits of competitive contracting are lost.

### **Conversion structures of success**

Virtually all transit system conversion to competitive contracting has been associated with administrative reform through "separation of policy from operations". Primarily, it allows the government agency to improve productivity through market-deter-

mined costs. Separating policy from operations removes potential conflict-of-interest that occurs when an agency evaluates its own and other proposals from external organizations. The government does maintain a crucial role in planning and subsidizing public transportation services. It retains full control over policy, routes, schedules, fares and service standards. Day-to-day operations of the system are turned over in whole or in part to the free market. Vehicles and maintenance facilities can be publicly or competitively provided. Both models have been used successfully in cities throughout the U.S. Contractors can provide service under the transit agency name, so the system will remain fully integrated.

### **Private-Sector Service**

Critical to advancing competitive contracting is that market entry is available to private-sector operators. A cursory study of operators available in the reviewed cities shows that should contracts become obtainable, the intact competitive forces can merely reposition their equipment to begin services. The timing of public knowledge of the movement toward competitive contracting also allows the entrepreneurs to get in place to make realistic bids.

A Metropolitan Transportation Association (MTA) study found that the typical Chicago area fleet operation has an average of 327 vehicles. With all U.S. operations considered, the average Chicago-area firm operates a fleet of 806 buses. The private sector operates 14,715 vehicles in the Chicago area. This is over seven times the number of buses operated by public transit in Chicago.<sup>20</sup>

The average Chicago area firm provides service to 30,753 transit riders per weekday, and 41,450 riders in total per weekday. (Transit ridership excludes school bus operations while this service is included in the estimates for total ridership). The total transit ridership of the private transit industry in the Chicago area is 1.8 million rides per weekday.<sup>21</sup>

### **Competitive Contracting in Illinois**

Private transportation provides one-third of the nation's school bus service, two-thirds of the nation's paratransit service for the elderly and disabled, and more than ten percent of conventional bus transit services. Also, in the urban areas reviewed in Illinois competitive contracting is

already working. PACE contracts out approximately 40 percent of its routes to the private sector. CTA contracts out all of its paratransit service for the elderly and disabled. Almost all of METRO service is contracted out to the private railroads. School bus and paratransit services are competitively contracted in five of the six cities surveyed. St. Clair County identifies its system as executing contracts, however, they only go to the St. Louis Transit Agency and that is a no-bid basis. Madison County is by far the most advanced in competitively contracting its general services. Nearly 100 percent of its entire services are contracted out.

Hindrances to the implementation of competitive contracting are the universal blocks to privatization in many municipal services — legislation, union opposition, misunderstanding of the methods, and in some instances — old fashioned politics.

The public pressure to become fiscally responsible and provide quality service is forcing cities to seriously strategize how competitive contracting can work in their communities. The reports are stacking up how regions and local communities will flourish and enjoy the benefits of the route expansions, increased ridership, quality service at lower costs, job security for existing public transit employees, and opportunities for minority businesses that can result from competitive contracting.

Throughout Illinois, with services already running, private operators standing-by, legislative efforts, and political strategy meetings taking place, the stage is set for more advanced competitive contracting in bus services; probably sooner than the general public may be aware and to its most welcome benefit.

### **Summary**

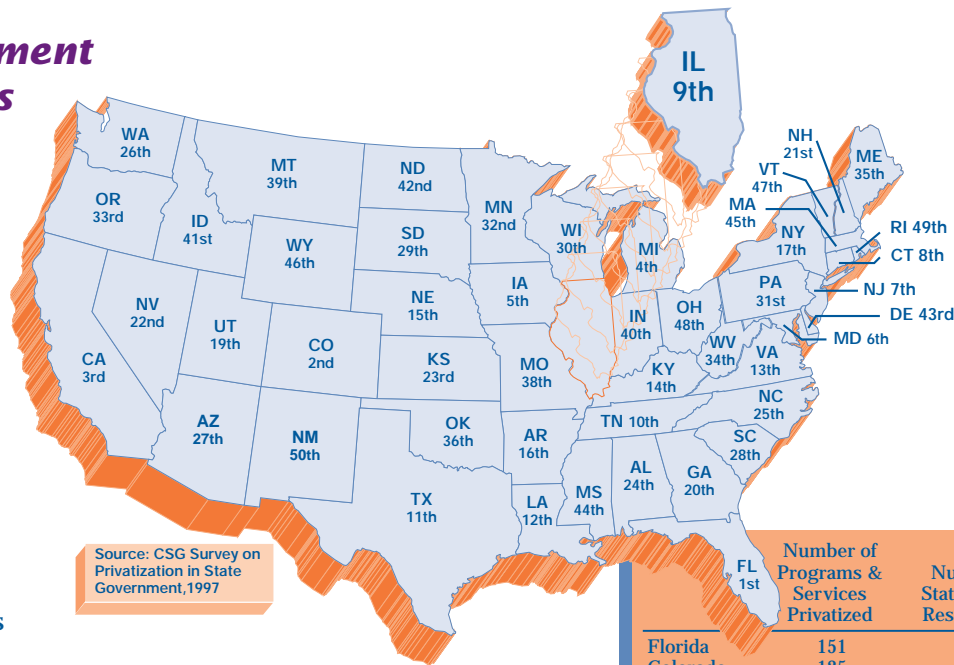
The link between increased infrastructure spending and greater economic development opportunities is clear. More state and local economic development agencies are recognizing this reality and pressing for infrastructure improvements that will create jobs and enhance their competitiveness. Because of massive infrastructure needs and limits on local government's ability to finance improvements, officials are turning to privatization as a

*See INFRASTRUCTURE, back page*



# Illinois Ranks 9th in Privatizing State Government Services

Illinois Ranks



One of the best ways to promote change in the way governments do business is to look at what has and has not worked in other states. This is one of the most important functions of the Council of State Governments (CSG), a nonpartisan organization consisting of elected and appointed officials from the legislative, executive and judicial branches of state government. Privatization is an issue that has been researched and monitored by the CSG since 1980. Following up on a survey in 1993, the CSG once again surveyed state governments in July 1997, to determine the level of privatization and to assess emerging trends. The results of this survey are summarized in a report entitled, "Private Practices: A Review of Privatization in State Government," and are examined in this article.

## State Rankings

The map illustrates the data provided in the table, with Illinois ranking ninth based on a total of 88 privatized programs and services. Florida, with 151 privatized programs, ranked first and New Mexico, with only 6 privatized programs and services, ranked last. The survey listed 15 government categories with numerous programs and services listed under each of these categories. Administration and General Services, Transportation, Corrections, Health, and Social Services are the categories in which Illinois privatized the most services and programs.

## Administration and General Services

Expectations regarding future privatization were high in this service category with 68.6 percent anticipating an increase in the next five years. Unlike other government function classifications, more than half of responding officials within this category used some systematic decision-making process in privatizing services. In addition to cost savings, respondents said that flexibility and lack of in-house personnel were the reasons for privatizing.

Illinois privatized 18 of the 36 listed programs and services under Administration and General Services. While Illinois was one of 23 states privatizing custodial services, it was one of the few to privatize state employee insurance and risk management. Some of the services privatized by other states but not in Illinois included: mail processing, bill collection, surplus property management, data processing, and museums.

## Transportation

This is the government function where services and

	Number of Programs & Services Privatized	Number of State Agency Respondents
Florida	151	16
Colorado	125	10
California	124	9
Michigan	119	11
Iowa	118	10
Maryland	118	10
New Jersey	112	9
Connecticut	90	14
Illinois	88	6
Tennessee	86	10
Texas	82	8
Louisiana	78	11
Virginia	76	8
Kentucky	73	7
Nebraska	68	10
Arkansas	61	10
New York	60	7
Hawaii	59	13
Utah	58	7
Georgia	56	7
New Hampshire	54	8
Nevada	52	8
Kansas	50	6
Alabama	49	10
North Carolina	49	10
Washington	49	9
Arizona	48	7
South Carolina	48	8
South Dakota	48	8
Wisconsin	48	6
Pennsylvania	47	7
Minnesota	46	6
Oregon	45	7
West Virginia	45	8
Maine	42	9
Oklahoma	42	6
Alaska	41	8
Missouri	41	8
Montana	41	4
Indiana	39	6
Idaho	37	8
North Dakota	35	9
Delaware	31	4
Mississippi	31	4
Massachusetts	30	3
Wyoming	29	7
Vermont	28	6
Ohio	26	4
Rhode Island	26	5
New Mexico	6	3





programs are most likely to be privatized; however, such privatization is not generally the result of a systematic decision-making process. A majority of respondents (57 percent) reported the privatization of over 15 percent of transportation services and programs and the majority of those are contracted out on a case-by-case basis through a "trial-and-error" process. The most common reason for privatization in this category is not cost savings, which was cited by 40.5 percent of respondents, but rather the lack of agency personnel and expertise (59.5 percent). Twenty-eight states indicated that they estimated cost savings; however, only three saved more than 15 percent as a result of privatization. Savings of less than five percent were reported by 19 of those agencies. Transportation agency respondents reported increased privatization in the past five years (76.2 percent). A smaller majority (59.5 percent) of these respondents anticipate increases in privatization during the next five years.

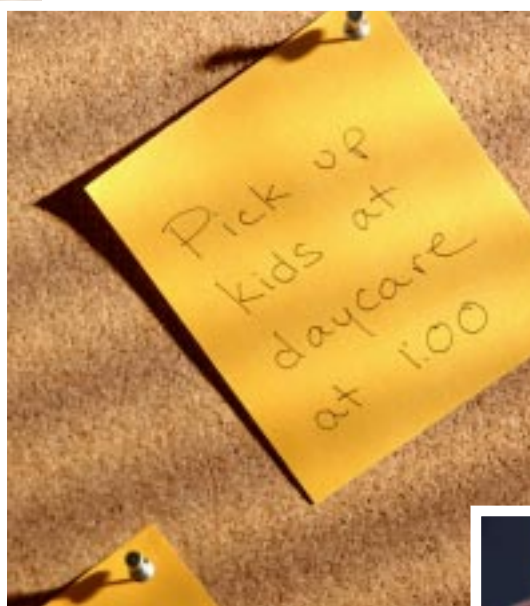
Like many other states, Illinois privatized many Transportation programs, 15 of the 30 listed programs and services. Of the top ten most privatized services listed that deal primarily with highway construction and maintenance, Illinois privatized all but grass mowing. Some of the other services listed in the survey but not privatized in Illinois were snow removal, map sales, toll booth operation, and security.

#### **Corrections**

Sixty percent of the 35 state agencies that responded in this category indicated an expectation that privatiza-

tion will increase in the next five years. Many of the most commonly privatized services involve the provision of medical, dental, or mental health treatment and laboratory services as well as general prison operations, facilities construction, halfway houses, food services, and education/training/community centers.

Texas reported privatization of 21 of the 28 listed programs and



services, the most of any responding state, while Illinois privatized 13 of the 29 services listed. Like most of the responding states, Illinois has privatized most all medical services. Other states have privatized prison operations, transportation of prisoners, and court-ordered monitoring.

#### **Health-related services**

With 11 of the 22 health-related services privatized, Illinois was comparable to the other responding states included under this category. Two notable services privatized in other states were drug and alcohol treatment and 5 states have privatized Medicaid processing.

#### **Social Services**

This was the category where the greatest number of respondents expected to increase privatization in the future and where many functions are privatized. Among respondents, 85.7 percent reported an increase in privatization over the past five years and 75 percent anticipated that privatization will increase in the next five years. Social service agencies do not

privatize primarily to reduce costs, and 76 percent of respondents reported savings of less than five percent. Instead, agencies cited lack of agency personnel and expertise as the most common reason, followed by increased political leadership and speedy implementation.

Social Services had 38 programs and services listed with Illinois included under 12 of them. While included under many of the most common services privatized such as, child care, food stamp issuance, emergency shelters, and refugee services, there were 26 other programs and services privatized in other states.

It should be noted that not all agencies responded to the survey. Florida ranked first in the number of responding agencies as well as the number of privatized services and programs. The number of states that responded ranged from 38 for Transportation to 14 for Treasury and the number of responding agencies varied even more. This may explain why



Illinois was not listed under certain services and programs, such as architectural services and asbestos removal, and not listed in some categories, such as Education. Therefore, rankings could change significantly if a comprehensive survey including all relevant agencies from every state were compiled. However, more important than the rankings are the survey results examining the trends and factors



affecting privatization in state government services.

### Overview of Survey Results

The survey revealed that privatization among state government agencies has increased during the past five years and a majority of responding agency directors (55 percent) and executive officials (55.2 percent) expect such activity to increase during the next 5 years. This expectation is supported by the fact that during the last decade, 14 states have established boards, councils or commissions to either promote or direct privatization efforts (Arizona, Colorado, Florida, Georgia, Kansas, Kentucky, Maryland, Michigan, New Jersey, New York, Texas, Utah, Virginia and Wisconsin) and 3 states (California, Illinois, and Massachusetts) have done so through governors' executive orders. Survey respondents revealed that most privatization efforts are done on an *ad hoc* basis rather than as a result of standardized evaluation or monitoring procedures. Those states that are promoting and assisting privatization efforts at a statewide level are establishing a favorable climate and providing the leadership that the report indicates is necessary to overcome barriers to privatization.

According to the survey, more services and programs are privatized within transportation agencies than any other agency surveyed. Twenty-two states (including Illinois) reported that more than 15 percent of their transportation programs and services are privatized. Social Services and Juvenile Rehabilitation programs also reported greater percentages of privatized services, particularly in southern states.

Of the agency respondents who reported cost savings, 14.6 percent estimated savings exceeding 15 percent, 20 percent indicated between 6 and 10 percent savings, and 62.3 percent estimated less than 5 percent savings. A majority (60 percent) indicated that cost savings were estimated rather than being directly computable. Regionally, the states reporting the least savings were western states while

A snapshot of privatization efforts by selected states during 1997, as reported by the Reason Foundation:

**Connecticut:** Efforts to privatize several government functions (data processing services, homes for the mentally retarded, and health services) have been promoted during the past year by the Governor, who estimates savings of over \$75 million a year, if implemented. Additional functions may include child support collection and some motor vehicle services, if approved by the legislature.

**Georgia:** The Commission on Privatization of Government existed for two years, beginning in 1995, in order to "change the culture of state government" and to look to privatization of projects in order to save taxpayers millions of dollars. Authority has been passed to agency heads to further privatization efforts.

**Illinois:** The Privatization '98 report published by the Reason Foundation described the partnership between the State Comptroller's office and Western Illinois University as a "key development" in the area of state government privatization during 1997. The partnership was initiated by the State Comptroller to establish and maintain the Center for Competitive Government on behalf of local governments in Illinois. The Center provides municipal, county and township officials with information and resources regarding privatization and other innovations to save money and improve financial management practices.

**Pennsylvania:** Agency data centers will be consolidated and their functions privatized in a major move that is anticipated to save \$127 million during the first 5 years and \$25 million annually after that.

**Virginia:** The Commonwealth Competition Council plans to incorporate employee ownership plans as part of the state's ongoing, "cutting edge" privatization efforts, which are reported to have saved over \$100 million so far.

Source: "Privatization '98: 12th Annual Report on Privatization," Reason Public Policy Institute

those reporting over 15 percent savings tended to be from the south and east. Greatest cost savings were reported in Administration and General Services, Mental Health and Retardation, and Parks and Recreation.

In addition to providing a listing of the functions currently being privatized by states, the report also provided guidelines and recommendations for officials considering privatization. Among those considerations discussed is a reminder that privatization is not abdication of responsibility on the part of the state. When services or programs are mandated, the appropriate state agency must still be accountable for the provision of those services or programs. Another key issue raised by the survey is the need for officials to employ mechanisms for determining cost savings that result from their priva-

tization efforts. Only by showing such savings will the benefits of privatization be fully appreciated and, as a result, expanded as needed. ■



## Legal Aspects of Privatization

This article highlights three legal issues regarding "outsourcing" or "contracting out": First, how can the government enable privatization? Second,

what are the legal barriers to privatization? Third, how should an outsourcing agreement be drafted?

### How Can the Government Enable Privatization?

Some jurisdictions have passed enabling statutes to facilitate privatization. For example, in 1994 Michigan's Governor Engler secured passage of a charter-school law, opening the way for private companies to run public schools. The Michigan legislature also took privatization off the list of mandatory subjects of bargaining in Michigan's collective bargaining statute, enabling schools to outsource cafeteria, custodial, transportation, and other such support services.

In addition, some governments have passed laws allowing government to operate more like a private sector business. For instance, Georgia enacted legislation abolishing civil service protection for state employees hired after July 1, 1996. The law reduces government rules that make it difficult to hire, promote, and fire and enables public employees to be judged on the basis of performance.

Some courts have also supported privatization efforts. For example, the Wisconsin Supreme Court upheld the constitutionality of education vouchers utilized in Milwaukee's school-choice program. The use of vouchers was found not to violate the separation of church and state.

### What Are the Barriers to Privatization?

First, union contracts and labor law may impede outsourcing or raise its costs. Labor agreements may prohibit outsourcing outright or condition outsourcing upon specific factual findings, such as cost-effectiveness. Courts in states including Illinois have held that subcontracting is a mandatory subject of bargaining. Therefore, governmental units considering outsourcing should determine the extent of any contractual limits on outsourcing



and whether there has been a waiver by the union of any further bargaining rights.

Second, state or federal statute can restrict the degree to which outsourcing is permissible. For example, Massachusetts' "Pacheco Law" makes it necessary to perform cost comparisons establishing that a private sector vendor can perform the services at issue more cost-effectively than the agency.

Third, the law can affect a government's financial leverage in privatization deals. Sometimes it provides financial muscle. For example, governments implementing public-private partnerships to spur development of economically disadvantaged regions may be able to offer tax increment financing as an incentive to investment. On the other hand, the law can also hamstring financing efforts. For example, government facilities built with the proceeds of tax exempt bonds may lose their tax exemption if they are sold to private entities.

### How Should an Outsourcing Agreement be Drafted?

When negotiating an outsourcing agreement, a governmental entity often addresses the following issues:

**Procurement Procedures:** Rigid bidding and evaluation procedures can be time consuming and administratively burdensome, but they also promote fairness and transparency, insulating privatizers against charges of

favoritism and unfair dealing.

**Goals Assessment:** By issuing Requests For Information, privatizers can gather ideas from a host of sophisticated, experienced service providers.

**Precise Terms of Service:** Clear scope of service provisions, realistic service level commitments, and measurable performance guidelines may help ensure that the government's expectations are met.

### Pricing Models and

**Procedures:** In selecting vendors, it's appropriate to make "apples to apples" price comparisons. In developing a contract, it's useful to clarify which conditions or events will trigger payment, which method or formula will be

used to calculate payment owed, and which government personnel will be authorized to oversee the vendor's performance and sign off on corresponding payments.

**Accountability:** If multiple vendors provide service, identifying a prime

contractor may enhance accountability.

**Indemnification:** Government entities may not be positioned to agree to boilerplate indemnification terms. For example, funding laws may restrict governments' ability to indemnify, and many states' laws require the state attorney general to assume control over state legal defenses. Indemnification terms may therefore need to be thoughtfully drafted.

**Risk Management:** The District of Columbia was sued over alleged medical malpractice by its privately-run prison's medical staff. Outsourcers may wish to consider negotiating risk management procedures into the contract.

**Anticipating Change and Conflict:** Negotiating change management procedures, contingency plans, and dispute resolution procedures can minimize the risk of service disruption.

**Exit Strategies:** Specifying events triggering the end of the relationship as well as mechanisms and financial responsibility for disentangle-ment is best done at the start of the relationship. ■





In the private sector, decisions regarding how to best accomplish a task are driven largely by cost factors and involve considerations such as efficiency, effectiveness, and profits. The government sector is more complicated. Certainly costs are important in the public sector. But operating decisions are also likely to be influenced by other considerations such as program restrictions embodied in state and federal laws and regulations, budgetary practices, attitudes, and political leadership. These factors can raise barriers to privatization, even in cases where privatization can provide better service at lower costs.

Even when government realizes it is in the public interest to operate as efficiently as possible, strict government controls and the lack of good management information serve as barriers to privatization. **To overcome these barriers, a privatization program requires the political leadership to oversee a complete rethinking of how government does its business.** To the extent interest groups, decision-makers, middle management, and labor are comfortable with current government procedures, they may defend barriers to proposed changes that threaten the status quo.

### Management Barriers

Governments have developed detailed management rules pertaining to personnel, purchasing, and contracting to ensure that hiring and spending satisfy legal requirements. Occupational responsibilities and operating requirements are clearly spelled out. However these rules were developed in a non-competitive environment which does not require the data gathering systems or the administrative flexibility of a private company whose continued existence is dependent upon out-performing its competitors. This aspect of government can be a barrier to privatization efforts.



For example, the core element of government accounting - the fund and line item accounting system - is designed to ensure budgetary compliance. These government accounting systems generally are not program or service activity oriented. Significant portions of agency budgets, such as central offices or EDP, are not structured so that agency spending can be associated with specific programs. This may make it difficult to unbundle portions of programs that are suitable for privatization. For example, how should costs be separated for shared facilities such as office buildings and computers and how should the cost of overhead such as central accounting and personnel be estimated?

Cost accounting and benchmarked performance data are essential to be able to undertake cost comparisons between competitors and evaluate the effectiveness and quality of service delivery. This data often does not exist in government and, thus, can be a significant barrier to privatization.



Indicators must be developed that allow government to measure how it is performing in comparison to other gov-

ernments and private service providers. Government needs a planning system which sets goals, measures the resources devoted to those goals, and evaluates how close program outcomes come to meeting those goals. Trying to privatize with no measurement tools makes it difficult, if not impossible, to evaluate the privatization effort. (See article on page 3 for more information on cost analysis.)

Standard government budget practices also discourage agencies from attempting to privatize parts of their activities. Agencies generating cost savings do not benefit from these savings. Under the "use it or lose it" system of budgeting, budgets may be reduced in the next year by the amount saved in the current year and agencies that do the best job in controlling



expenses get the smallest budget increases. State agencies need greater flexibility between line items, as well as the ability to use at least some of the savings from one fiscal year in the next.

Government contract requirements can also serve as a barrier to privatization. The many conditions attached to receiving a government contract can discourage bids from alternative service delivery firms with little experience in dealing with the government.

In some service areas, contract requirements and small market size may lead to a lack of interested service providers, even if there is a strong desire to privatize. Logically this barrier should apply to smaller rural cities and towns, but survey results from the Illinois Center for Competitive Government suggest that it is of some concern in cities of all sizes. In the pri-



vat sector, large companies often help create the small sub-contractors that serve them. State and local small business development agencies should be able to help create service providers in areas where there are currently no companies available to meet privatization needs.

Another barrier to successful privatization is that management has to change the way it does business. Administering a program contracted to an outside firm is different from run-

ning the same program from within a government agency. Except for privatization options such as asset sales or service shedding, government does not abdicate its legal responsibilities when it privatizes services. Rather, it assumes a new role and function in the oversight of privatized services. This also usually requires new skills among government employees including preparing requests for proposals, administering contracts, monitoring performance, and analyzing costs. The lack of these skills may not necessarily prevent privatization from moving forward, but exposes the government to risks and liabilities which might not otherwise be present. In studies of privatization conducted by both the Council of State Governments and the U.S. General Accounting Office, governments generally cited contract management, monitoring, and evaluation as the weakest part of their privatization programs.

A distinct risk is a failure of the privatization plan. If written by a skilled contract administrator, the privatization agreement would contain contingency provisions defining obligations if the private entity that takes over a program can no longer operate that program. Without such provisions, vendor failure could leave a government program in limbo.

### **Labor Opposition**

A common barrier to privatization is opposition from affected government employees. (A Reason Foundation survey of large U.S. cities found 85% had obstacles from employee unions.) State employees normally receive civil service protection and membership in guaranteed government pension plans, in addition many benefit from union membership.

Labor opposition is based on the perception that privatization is a serious threat to these benefits. The concern is that privatization will reduce program costs by either reducing the wages and benefits of existing employees or by replacing these workers with lower wage, lower benefit substitutes. Another labor concern is that the reduction in employment levels will be so severe as to lead to a significant decline in the quality of services.

Union contracts and labor law may impede outsourcing or raise its costs. Labor agreements may prohibit outsourcing outright or condition outsourcing upon specific factual findings, such as cost-effectiveness. Courts in

states including Illinois have held that subcontracting is a mandatory subject of bargaining. (See Legal Aspects of Privatization.) Therefore, governmental units considering outsourcing should determine the extent of any contractual limits on outsourcing and whether there has been a waiver by the union of any further bargaining rights.

The solution is to involve employee representatives in all phases of the privatization process. Being included in the process will ease public employee fears of privatization and minimize the disruption from the transition to a competitive environment. Early employee representative involvement will be essential if privatization requires bargaining over issues contained in union contracts.

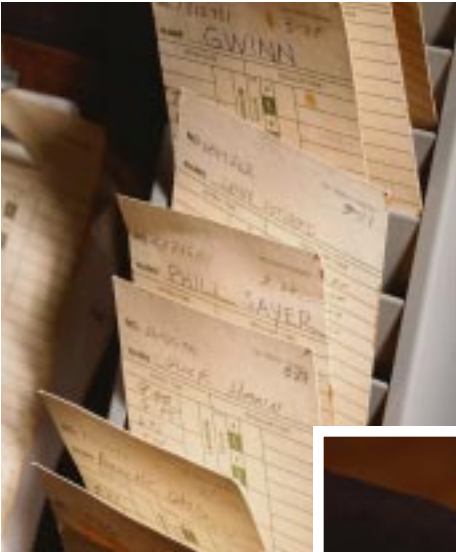
Many options have been proposed which protect employees and may even increase their job satisfaction. The existing service providing agency could combine professional assistance and in-house expertise to become a competitive bidder for privatization contracts. The experience of privatization in cities such as Indianapolis, Phoenix, and Milwaukee shows that public workers can win in competitive bidding against private vendors. Besides their experience, public agency bidders also benefit from not having to pay taxes or earn dividends and by starting with the existing paid for capital stock.

The existing public agency could be replaced with a private entity, in which existing employees have an ownership interest and receive a share of the dividends, to bid on the privatized project. The concept of employee ownership has become increasingly popular in the private sector with over 10,000 U.S. companies owned in part by ESOP's (Employee Stock Ownership Plans). There is no reason a similar concept could not be applied to the public sector.

There are several ways to minimize layoffs. If the pace of privatization is set equal to the employment attrition rate, employees of the privatized departments can be transferred to replace retiring employees. The result is privatization without layoffs. An early retirement option would lead to higher attrition and increase the no layoff rate of privatization.

Successful private bidders can be encouraged to give first consideration





to existing employees. For the sake of labor peace, it might even be reasonable to guarantee jobs at existing wages for current employees, but allow the contractor to have wage flexibility for new hires. However, clear barriers to privatization

include laws that unilaterally prohibit private contractors from paying lower wages than government employees who perform the same work, or civil service rules that limit the use of outside employees for state work. Special training for employees switching from the public to the private sector would also ease the transition to competition and make the hire of these employees more attractive. To the extent layoffs are avoided, privatization will present no special difficulties for minority or younger low seniority workers.

Pension portability for employees transferred to the private sector would reduce concerns that benefits in the private sector will not match those in the public sector. This could be done by allowing employees to transfer their government credit to the private employers pension plan or by rolling vested pension credit into an IRA.

### Legal Barriers

Many programs are governed by detailed legal provisions that restrict managerial flexibility in providing public services. These restrictions reflect the belief that public officials should retain responsibility for public programs. With privatization, there is a perceived loss of control which can generate opposition from elected officials and interest groups - and be a barrier to any efforts to privatize. The

concern is that contractors will not be as responsive to public concerns as elected officials. A strong monitoring and evaluation process can counter these fears. Advocates of privatization need to emphasize that privatization will not eliminate government's role. Instead, responsibilities will switch from operations to oversight.

Legal barriers to privatization also are backed by beneficiaries of subsidized services who fear their purchase prices will increase if subsidies are lost through privatization. Advocates of



privatization need to show how the streamlining from privatization in a competitive environment will often lead to better service and prices that are competitive with the subsidized charges. Reducing subsidized services can also be reflected in lower taxes to the benefit of all citizens.

State or federal statutes can restrict the degree to which outsourcing is permissible. For example, Massachusetts' "Pacheco Law" makes it necessary to perform cost comparisons establishing that a private sector vendor can perform the services at issue more cost-effectively than the agency. A study by the staff of the Joint Economic Committee of the U.S. Congress lists examples of legal barriers set by the federal government for state and local government privatization. An airport would seem to be a government owned facility that could be easily privatized. However, federal airport grants require the owner to put all revenues back into the airport. This policy might prevent an airport from diverting grant-related monies to non-airport uses, but it would also discourage a potential private buyer of the airport who might have to invest all profits back in the airport.

In some cases, privatization can increase potential legal liabilities as the

private contractor lacks the limits on lawsuits that benefit government bodies through sovereign immunity. However, negotiating risk management procedures into the contract can help minimize tort and other legal exposures. The law can also hamstring financing efforts. For example, government facilities built with the proceeds of tax exempt bonds may lose their tax exemption if they are sold to private entities. This might prevent a government from using tax exempt bond sales to benefit a private entity, but it also serves as a barrier to privatization. (See Legal Aspects of Privatization for additional legal issues concerning privatization).

### Recommendations

A comprehensive privatization program can only succeed with leaders willing to champion the cause of privatization and more efficient government. These leaders will have to work to organize a like minded coalition to address each of these barriers, whether they come from taxpayers, employees, managers, or appointed and elected officials.

Once there is a movement toward privatization, support agencies are needed to provide technical assistance through the difficult stages of implementation. Some states have created privatization agencies (such as the Virginia Commonwealth Competition Council or the Maryland Council on Management and Productivity) or assigned privatization responsibility to a central administrative agency. These agencies serve as advocates of privatization, educate managers and officials on the merits of privatization, and provide guidance to agencies undertaking a privatization program.

Another resource would be a university affiliated institute that could provide technical assistance to agencies and academic evaluations of ongoing privatization efforts. Legislative involvement could start with a complete review of government statutes and regulations to identify those that serve as barriers to privatization. The independent commission or legislative committee that makes the review could also be charged with recommending amendments to ease the ability to privatize government activities. ■



# P rivatization in Illinois

In its recent report reviewing lessons learned by state and local governments, the General Accounting Office (GAO) concluded that "privatization can best be introduced and sustained when there is a committed political leader to champion it." The GAO also found that governments need to establish some type of organization to oversee implementation and may need to enact legislation or resource reductions to encourage privatization.

Skipp Stitt, former Deputy Mayor of Indianapolis and founder of Competitive Government Strategies, LLC, says that his experience suggests privatization generally occurs under one or more of four conditions: aggressive, charismatic leadership on privatization; new leadership and a change of direction; a fiscal crisis; or a regulatory crisis.

Privatization of government service delivery is not a new concept in Illinois — many services have been privatized for decades. But the conclusions above strongly imply the need for some external driving force to push and promote privatization in government service delivery. This is the experience of many state and local governments. How does Illinois' experience compare?

## Illinois Needs a Political Champion...

Illinois lacks the political leadership cited above to champion and sustain privatization as a major strategy in the delivery of government services. While the State certainly experienced fiscal crisis over the last decade, privatization does not appear to have played a central role in restoring the State's fiscal health. In terms of political leadership, there were two important initiatives aimed at advancing the privatization of government services.

**The Private Enterprise Review and Advisory Board.** In 1991 Governor Jim Edgar established the Private Enterprise Review and



Advisory Board and charged it to examine the issue of privatization in government. The Board's 1993 report represents the most comprehensive work to date on privatization in Illinois state government.

The Governor apparently envisioned a rather ambitious agenda when he established the Board. A review of his executive order indicates that the Board was to:

- determine whether the State's interest could be better served both by turning some activities currently performed by government over to the private sector and by returning other activities currently performed by the private sector to state government;
- assess the complaints of business, especially small business, with the competitive practices of state government which may inhibit the commercial activities of the private sector;
- identify areas of local government with privatization potential, including a recommended process for



evaluating such opportunities; and

- provide a report with recommendations and proposed legislation.

The Board identified more than 250 state government activities already privatized and more than 60 state government activities where efficiency might be increased through either privatization or de-privatization. More significantly, the Board made numerous recommendations regarding privatization in state government. These included recommendations for a standardized procedure to review new and existing programs and a proposed protocol for determining the privatization potential of government activities. The Board did not address the charge to



assess the complaints of business nor to study areas of local government for privatization potential.

The response and follow-up to the Board's report were mixed at best. Upon its release, news accounts emphasized stories of labor opposition and suggestions by at least one private sector member that the Board's work was not taken seriously.

**The Illinois Center for Competitive Government.** In 1997 Comptroller Loleta Didrickson, in partnership with Western Illinois University, organized the Illinois Center for Competitive Government to work with local officials in improving the depth and quality of local government through initiatives such as privatization. In its *Privatization 1998*, the Reason Public Policy Institute cited the Center's establishment as one of only two significant, state-level developments in 1997.



In cooperation with the Illinois Institute for Rural Affairs and the Illinois Municipal League, the Center completed a detailed survey on privatization in Illinois municipalities. *Competition for City Services: Has the Time Arrived?* serves as a rich source of data and information on the privatization trends and lessons learned by local governments in Illinois, including the scope and types of privatization, reasons for privatization, barriers, and sources of information.

Beyond these two explicit initiatives, however, there is no other broad-scale political leadership to sustain a privatization strategy at the state or local levels. Privatization of government services depends to a large extent on leadership within individual state agencies or local governments.

## State Government Lacks Strong Policy on Privatization...

As a matter of standard operating procedure, the federal government has had a long-standing, explicit policy on privatization of government services dating back to 1955. It is official policy of the federal government to procure products and services from the private

by establishing government-wide institutions for oversight, support, and technical assistance. Fourteen states have organized privatization boards, commissions, or councils for this purpose. These units typically provide criteria for selecting privatization activities, identify privatization candidates, develop method-

ologies for cost comparisons and evaluations, and propose procedures for monitoring and oversight of privatized activities. Except for the Review and Advisory Board's report, however, it appears that Illinois state agencies interested in privatization will be very much on their own, with little institutional support within

### Statewide Privatization Boards, Commissions and Councils

State	Name
Arizona	Private Enterprise Interview Review Board
Colorado	Commission on Privatization of Personal Services
Florida	Council on Competitive Government
Georgia	Governor's Commission on Privatization
Kansas	Kansas Council on Privatization
Kentucky	Governor's Commission on Privatization
Maryland	Council on Management and Productivity
Michigan	Michigan Public-Private Partnership Council
New Jersey	Advisory Council on Privatization
New York	New York State Research Council on Privatization
Texas	Council on Competitive Government
Utah	Privatization Policy Review Board
Virginia	Commonwealth Competition Council
Wisconsin	Commission on Privatization

Source: *Private Practices: A Review of Privatization in State Government*, The Council of State Governments, March 1998.

sector whenever possible, unless the government can provide the service at a lower cost, based on detailed cost comparisons. The policy also identifies a huge range of services which exemplify "commercial activities."

Illinois, on the other hand, lacks any explicit policy requiring agencies to consider privatization of government services as part of their routine management and decision-making processes. As noted above, the Private Enterprise Review and Advisory Board made a number of substantive recommendations, but there is no evidence that either these recommendations or other directives were formally adopted and transmitted to agencies as official policy.

In the area of legislative policy, there were a dozen bills on privatization introduced in the last three General Assemblies, none of which passed. Two of these bills were clearly intended to regulate the privatization activities of state agencies. While privatization is not discouraged, neither does it appear to be encouraged or promoted by state policy.

## There Is Little Institutional Support for Privatization...

Some state and local governments promote and encourage privatization

state government to support them. Local governments, on the other hand, may call on the Illinois Center for Competitive Government for such services and support.

Illinois' approach seems generally consistent with the findings of a recent survey by the Council of State Governments. More than 70 percent of state respondents reported that they had no comprehensive government privatization initiatives. Instead individual agencies privatize their activities as necessary and manage the projects on a case-by-case basis. Even the Reason Foundation noted in its 1998 report that states were "not hotbeds" of privatization in the prior year.

## Privatization of Government Services in Illinois

At individual Illinois agencies, as in most states, many support services have long been at least partially privatized. Some of the most popular targets have been: data entry, janitorial services and other building and equipment maintenance activities, security, pest control, graphic design and printing, mass mailings, court reporting, certain legal services requiring special expertise, advertising and promotions, temporary clerical support, special research and consulting services, and software development and support.





**Examples of Privatization Efforts At Illinois Agencies  
Before FY 1994 (Programs that are at least partially privatized)**

Program	Agency
Annual State Agency Audits	Auditor General
Community Care	Aging
Employee Health and Life Insurance Administration Employee Health and Life Insurance Utilization Risk Management Services	Central Management Services
Foster Care Institutions and Group Homes Counseling Homemaker Family Preservation	Children and Family Services
Domestic and International Advertising Bank Loan Servicing Training and Education	Commerce and Community Affairs
Hazardous Material Removal Hazardous Material Testing Asbestos Testing Vehicle Emissions Testing Site Cleanup Tank Cleanup Certification	Environmental Protection Agency
Drug Treatment and Prevention Mental Health and DD Services Community Health Services Community Youth Services Welfare-To-Work (Transition Services) Day Care Services Violence Prevention	Human Services
Advertising and Promotions Sales Agents On-Line Ticket Computer Network	Lottery
Lodges and Concession Facilities Appraisal Services Research Studies Test Drilling Mapping Laboratory Testing	Natural Resources
Medicaid Medical Utilization Review Genetic Testing	Public Aid
Lock Box, Tax Payment Processing Electronic Filing Collection Agencies Circuit-breaker Administration	Revenue
Child Nutrition Professional Development Individual with Disabilities Education (IDEA) Bilingual Education Early Childhood Program Assessment	State Board of Education
Highway Construction and Maintenance Rest Area Maintenance Airport Construction Waterway Construction Archaeological Studies Engineering Studies Aerial Mapping Appraisal Services	Transportation

**Examples of Privatization Efforts At Illinois Agencies  
Since FY 1994 (Programs that are at least partially privatized)**

Program	Agency
Office Supply Stores Print Shop Portions of Garage Operations ** Additional Telecommunications Services **	Central Management Services
Medicaid Certification Support ** Licensing services ** Child Protective Services **	Children and Family Services
Cooperative Ventures for Highway ** Tourist Information Centers Interactive Tourist Information Computer System **	Commerce and Community Affairs
Emissions Allowance Trading Clean Break	Environmental Protection Agency
Electronic Benefit Payments **	Human Services
E-Commerce	Office of the Comptroller
Key Information Delivery System KIDS (Child Support Enforcement) Income Withholding and Support Order Modification Kid Care (new in FY 1999) Electronic Benefit Payments ** Medical Claims Processing ** Child Support Payment Collection **	Public Aid

\*\*Denotes recommendation made in the 1993 *Private Enterprise Review and Advisory Board Report*.



States have also been privatizing some of their core functions. In some cases, those efforts have been considerable. State governments generally are not in the business of directly building roads, bridges, and office facilities. They also seldom (if ever) directly employ the medical professionals providing medical care to Medicaid recipients. These functions have long been provided by the private sector under the watchful eye of government officials. Nevertheless, these activities are still considered under the heading of privatization.

On the following page are some examples of Illinois' use of privatization to address both old and new issues.

### General Government Services

Some state agencies are specialized in that they serve a relatively narrow segment of the population. Others are more generalized and serve a broader constituency. Still others exist



### A Different Twist To "Privatization"— Getting Serious About Receivables

Privatization is generally thought of as efforts to get the private sector more involved in the day-to-day operation of government. However, an activity can also be "privatized" in the sense that it incorporates sound private sector business practices. The state's effort to collect its old debt is a good example.

Unlike fine wine, accounts receivable do not age well. According to U.S. Department of Commerce statistics, after 90 days, the odds of collection shrink 0.5% per day. After 180 days, the trail on most debt grows ice-cold. Industry experts know that the key to any successful debt recovery program is an aggressive early collections philosophy. That is the posture shown by the Comptroller's Office since early 1995.

Under Illinois law, the primary responsibility for the timely collection of debt owed the state rests with individual state agencies. The Comptroller's Office performs several functions related to debt collection. First, the Comptroller establishes accounting rules, guidelines, and procedures to help agencies determine, age, track, write off, and report their accounts receivable. Second, the Office annually reports the status of accounts receivable to the Governor and General Assembly based on information filed by agencies. Third, to help agencies in their efforts, claims can be submitted to the Comptroller's Offset System. This system intercepts and withholds state payments (such as state payrolls, lottery winnings, vendor payments, and tax refunds) to individuals and businesses that owe the state money. Finally, the Comptroller serves as a member of the Debt Collection Board, along with the Director of the Department of Central Management Services

and the Attorney General.

Comptroller Didrickson has taken the lead in seeking legislative changes that improve the likelihood of collecting from "deadbeats" who are indebted to the State. One of those measures took effect January 1, 1998. Under prior law, debts that exceeded \$1,000 and were more than 1 year past due were required to be placed in the Comptroller's Offset System. With the new law, that time has now been reduced to 90 days past due. Having the debtors in the Offset System on a more timely basis has shifted the emphasis from old debt to debt that is more likely to be collected.

Another ongoing effort to monitor and improve agency debt collection is the Comptroller's Office quarterly and annual receivables reporting. One part of this process requires agencies to identify and report on specific efforts made to collect substantial debt that is more than 180 days past due. Specific efforts include: letters; phone calls; skip tracing to confirm the current location of the debtor; searches for predecessor-successor relationships used to mask the closing and restarting of businesses; asset searches; face-to-face meetings; notification of credit agencies; bank levies; and judgment and lien filings. Agency efforts to use these private sector tools are reviewed and the numbers are analyzed based upon industry standards and benchmarks. The results of this analysis are then reported in the Comptroller's annual receivables report. Through these reports, agencies can see how they measure up in their collection efforts.

Another legislative change sought by the Comptroller, changes the way the Debt Collection Board does business. The Board was

established in 1987 and charged with selecting several outside collection firms and recommending that state agencies utilize the services of these specialists to help collect on their accounts receivable.

The new law, along with the legal rules proposed by the Comptroller and adopted by the Board, authorize the Illinois Debt Collection Board to assume responsibility for state agency accounts receivable if, after 180 days, the receivables have not been collected, are not subject to a current repayment plan, and have not been certified as uncollectible. This "last call" not only gives state agencies the opportunity to pursue aggressive collection activity when receivables are young and most easily collected, but also enables the Board to assure timely resolution when state agency efforts are not productive.

In addition, the Comptroller sought, and won legislative approval, for a measure that allows the Department of Revenue to publish at least once a year the name, address, and specific tax information for any taxpayer whose debt to the state is more than \$10,000 and has been unpaid for more than six months. Publication can take the form of a stand-alone document, or can be posted on the Internet. The provision includes safeguards against false accusation of delinquency and exempts delinquencies that are subject to a payment plan or taxes under appeal.

Connecticut has a similar law. Of the more than \$50 million in delinquent accounts that have been submitted to or disclosed by the Connecticut "Public Stockade", approximately \$25 million, or one-half, has been collected.

primarily to serve state government.

For example, the Department of Central Management Services privatized state employee health and life insurance administration and utilization review and risk management several years ago. More recent Department initiatives include privatization of office supply stores, printing, portions of central garage operations, and several telecommunications operations.

Also within this category, the Office of the Auditor General uses outside auditing firms to conduct audits of state agencies. In addition, the Department of Revenue uses outside help for lock boxing tax payments and administration of the Circuit Breaker (Pharmaceutical Assistance) Program.

### Information Technology

As technology has grown more and more sophisticated, it has become increasingly difficult and cost prohibitive to maintain in-house expertise. This is true in the private sector, as well as the public sector. Privatization efforts in Illinois reflect this fact.

Data entry is perhaps the most commonly outsourced computer-related activity, with most state agencies using some form of outside help. In fact, some agencies have been farming out this activity since the early 1970s.



## Privatization, cont'd

A somewhat more recent development is the privatization of software development and support, and large-scale systems development. Although many agencies have been using outside computer consultants since the early 1980s, this practice has expanded in recent years, reflecting the growing need for rapid turnaround and specialized expertise, and the increased willingness to use sophisticated computers to handle complicated tasks.

While computers are being used to improve the performance of many everyday tasks, they are also being used to perform many new activities, sometimes because technological innovations reduce costs and sometimes because innovation makes tasks possible that were not feasible previously. There are numerous examples of state agencies turning to the outside for help at the beginning of new projects. Examples include the on-line ticket computer network at the State Lottery, the electronic benefits payment systems at the Departments of Human Services and Public Aid, electronic tax filing at the Department of Revenue, the interactive tourist information computer system at the Department of Commerce and Community Affairs, and the Key Information Delivery System (KIDS) at Public Aid.

Another example is the Comptroller's new E-Commerce initiative using the Internet. The Office is partnering with LaSalle Bank to allow the State to pay vendors through the Automated Clearing House (ACH) network. A web site will allow vendors to provide their banking information to the Comptroller's Office. This secure, PIN-based system will make the enrollment process efficient, fast and accurate.

### Human Services

The State has a long history of using the private for-profit and not-for-profit sectors to deliver human services to the citizens of Illinois. In fact, publicly-funded human services are seldom provided directly by state employees. The philosophy throughout the human service agencies has been to strongly support the delivery of services at the local level by community-based organizations. This philosophy is apparent in the delivery of services to the aged through the various

community care programs at the Department on Aging. At the Department of Children and Family Services, the Foster Care, Institutions and Group Homes, Counseling, Homemaker, and Family Preservation programs reflect the long-term involvement of the private sector. This is also true of programs at the Department of Human Services, including: Drug Addiction and Treatment programs; Mental Health and Developmentally Disabled Services; Community Health and Youth Services; Day Care; and Violence Prevention.

Even with a long-term commitment to delivering services as close to the need as possible, there has been notable growth in the involvement of the private sector in recent years. Spurred in part by court decisions, the caseload at the Department of Children and Family Services jumped 191% between fiscal years 1989 and 1998. Over the same period, the percentage of cases under the care of private providers jumped from 25% to 77%. In addition, private providers now administer 100% of the services under the Institutions and Group Homes, Counseling, and Homemaker programs, as well as 90% of the services under the Family Preservation program.

### Education and Employment Training

Privatization in elementary and secondary education can be viewed from both a micro- and macro-perspective. The micro-view involves providing educational and support services directly to students while the macro-view involves providing oversight and support services to local school districts.

The micro-perspective is the responsibility of local school districts. In Illinois, state government provides money to local districts in the form of grants. Local districts, in turn, use outside vendors to provide a variety of services. Various studies confirm that there is substantial private sector contracting of noneducational support services. Transportation and food services are the most likely to be contracted out.

The macro perspective is the responsibility of the State Board of Education. At this level, privatization takes two forms. The first is related to support services provided to local school districts. The second is a mat-

ter of statewide policy regarding educational services.

In terms of statewide support services, the state Board of Education uses outside contractors for standards development, technical consulting, measurement, teacher training, and technology literacy.

Nationally, privatization of educational services has become closely linked with educational reform. While they are not the same, privatization is one tool which activists believe offers much promise for educational reform. Many employment and training services and programs have been privatized for decades.

Privatization of educational services is growing. This may range from the privatization of a particular service or class to privatization of an entire educational system. The tools available include both direct and indirect approaches such as deregulation through charter schools, contracting or outsourcing to the private sector, private scholarship programs designed to equalize educational opportunities by paying a portion of tuition for private scholarship schools, and tuition tax credits and deductions.

While still somewhat limited, Illinois continues to examine and experiment with several of these tools. Under a 1995 Illinois law authorizing up to 45 charter schools, individuals and public and private organizations may start such schools under sponsorship of the local school board. As of August 1, 1998 Illinois has opened seven charter schools and approved another nine to open. SABIS Educational Systems, Inc. had its charter school application approved to serve 1,000 Chicago students in the 1997-1998 school year and another 2,500 in subsequent years.

In 1995 Sylvan Learning Centers, Inc., a private company, contracted with the Chicago school system to teach children in 11 schools. Subsequently, it also contracted with the Chicago system to train student tutors.

While religiously affiliated programs have provided school choice for many years, in recent years the Chairman of the Golden Rule Insurance Company popularized the concept of privately-funded scholarship programs. The Chicago area currently has three of these programs, serving 480 students during the 1997-1998



school year in more than 44 participating schools, with another 437 students on waiting lists. Chicago's Link Unlimited program has been providing scholarships to inner-city African-American students since 1966.

Tuition tax credits and deductions for private school tuition remain a controversial issue. They have been enacted in Minnesota and Iowa, and Illinois has reviewed the concept.

Many employment and training programs funded by both the state and federal governments rely heavily on the private sector for service delivery. The federal Job Training Partnership Act Program (JTPA) administered by the State delivers services almost exclusively through a network of local, private consortia and service providers. The Department of Commerce and Community Affairs relies almost exclusively on private employers for employee training in its Industrial Training Program (ITP), while a similar program of the Prairie State 2000 Authority uses both vouchers and employer contracts for workforce training.

### **Economic and Infrastructure Development**

Another area where there is substantial privatization of state government activity is economic and infrastructure development. Some may be more obvious, while others less so.

It is not surprising to find that state government has almost from the beginning relied on privatization for typically 'commercial' activities. These include such activities as advertising for domestic and international tourism or the lottery, promotions and ticket sales for the lottery or state fair, and contracts for state fair grandstand operations such as talent searches and individual performers. In fact, the Department of Agriculture has proposed total privatization of the grandstand operation, but this would require a change in state law.

The transportation function is an excellent example of the potential impact of privatization of government services. The Department of Transportation (DOT) contracts out the majority of highway and airport construction and maintenance. Rest area maintenance is furnished through contracts with not-for-profit organizations. The Edgar Administration provides examples of public-private partnerships in its insistence on joint fund-

ing of major initiatives such as a proposed third Chicago airport, high-speed rail, and the funding of the Chicago-St. Louis Amtrak train.

The Capital Development Board (CDB) contracts out virtually all construction, renovation, and remodeling of state facilities, as well as engineering, architectural, and cost estimation assistance for state agencies. CDB is almost a pure example of the role many believe government employees will increasingly play in the future — that of project and contract managers.

### **Environment and Natural Resources**

The environmental and natural resources function of government presents numerous examples of the impact of privatization on state government.

Deregulation is an acknowledged, though emerging, technique for privatization where government de-emphasizes its regulatory function and powers in favor of private, market-based approaches to achieve the same ends. An innovative example of this approach in Illinois is the Environmental Protection Agency's emission allowance trading program. Illinois firms are issued tradable emission 'allowances', which decline in value over time, but provide pollution sources greater flexibility in making emission reductions.

Another innovative approach from the Environmental Protection Agency is its Clean Break Program, designed to offer small businesses an amnesty and greater flexibility in cleaning-up and controlling pollution. EPA has since partnered with private industrial and manufacturers' associations to operate the program. Companies who are members of these associations may now sign-on to the program through their associations.

Technical functions requiring specialized skills such as environmental testing and hazardous waste removal have been privately contracted by agencies such as the Environmental Protection Agency and the

Department of Natural Resources.

### **Conclusion**

Although there has not been any systematic follow-up to the recommendations of the Governor's advisory board, state agencies have continued their individual efforts at privatization. In the absence of strong political leadership, public policy, or institutional support, however, they appear to be very much on their own. They will have little institutional support in the face of determined opposition, and they may in some instances even find themselves battling their own governmental bureaucracy. And although most governmental agencies employ competitive bidding practices, the concept of managed competition, at least between the public and private sectors, does not appear to be a major driving force.

On the other hand, Illinois' approach to privatization appears to be very pragmatic, designed to address specific needs and objectives. Illinois government agencies appear more than willing to use privatization when it addresses or solves specific problems. Illinois governments, especially larger cities, cite cost savings as a major reason for privatizing services, but there are also many other reasons cited. These include the need for specific or technical expertise, internal service delivery within government agencies as opposed to outside customer groups, the cyclical nature of some operations requiring less than full-time staff, and external demands like stringent federal requirements. Privatization of government services in Illinois appears to be less of an ideological or philosophical issue than a practical management tool. ■



further incentive to look to the private sector as a source of quality services at less cost to taxpayers. As the use of privatization has grown, officials from both the public and private sectors are learning valuable lessons on how to overcome potential obstacles and make the contracting process work smoothly and successfully.

This issue of *Fiscal Focus* provides an in-depth look at privatization and examines a variety of issues of concern to public officials, employees and managers, the private sector and taxpaying citizens. Before exploring other areas of interest, it is useful to provide an historical perspective on privatization including global and nationwide trends, factors that make privatization successful, and potential obstacles. First, this article will look at the various types of privatization and provide a working definition.

**Defining Privatization.** The term privatization can mean different things. To proponents, it is a way of providing public services at the same or less cost by using competition to make government more efficient. To opponents, privatization is seen as a threat to the livelihood and standard of living of public employees and a loss of government control over service delivery.

In the broadest sense, privatization means shifting responsibilities and functions from the public to the private sector. It involves relying more on private institutions, such as businesses, nonprofit organizations and volunteers, and less on government for public service provision. Responsibility for a service can be transferred in whole or in part to the private sector.

Because the modern trend in privatization deals more often with management and supervisory services, the term competitive contracting is increasingly used. This term is more accurate in that many so-called privatization programs rely on a competitive bidding process in which the public sector may be one of the bidders.

Because the role of government is so commonplace in modern society,

there are numerous activities with the potential to be privatized. This means there are various forms of privatization that depend on the nature of the service to be privatized. For example, privatization can mean the sale of assets to the private sector. In most instances, government will not have any further role with respect to the sold assets. This occurs commonly in former East-bloc and Third World countries that are shedding centuries of publicly-

owned assets and turning their ownership and operation over to the private sector. An example in the United States would be

the federal government's sale of Conrail assets to private investors.

The most common form of privatization is contracting for service with private or nonprofit entities. Under this approach, the government retains financial and policy control over the service while a private firm renders the service. This type of privatization is commonly found at local levels of governments where, for example, many municipalities contract for garbage collection services.

There are two basic models of contracting for a service. First, companies can use their own employees and equipment to provide the service. An

example of this may be private prisons or solid waste collection. Companies may also be used to manage public employees, with government owning the structures or equipment. Airport management is often such an example. Under franchise or concession agreements, governments award a right to provide services within a specified area. Private organizations provide the service with payment going directly to the firms by citizens. The government may impose regulations on franchises and concessions, such as price controls and service standards. Cable television is a common example of a franchise agreement while a familiar concession would involve a snack bar at a public park.

Some governments have utilized vouchers as a method to privatize services. Under a voucher system, coupons or tickets are given to citizens needing a particular service. The citizen can then choose a service provider from competing public or private organizations that have been designated as eligible to receive the vouchers. A voucher system enables citizens to choose the service provider that best meets their needs and keeps services affordable by instilling competition among service providers. Examples would include school voucher systems in place at school districts in Milwaukee and Cleveland.

**Mythologies of Privatization.** There are a number of myths surrounding the increasing usage of privatization as a management tool. There is a widely held belief that privatization is a new concept. In fact, government has partnered with the private sector throughout history. Columbus was a private contractor hired by King Ferdinand and Queen Isabella to open new trade routes to India. The modern trend is really a reversal of a 20th century shift from the private sector to the public sector.

Second, there is often an erroneous assumption that certain services must be provided by the public sector. Today, virtually all mass movement public transportation is owned and operated by local governments. Yet, little more than a generation ago, these services were performed by privately-owned companies. In many ways, the modern trend toward privatization is



not unique, but a partial restoration of historic private sector involvement. Unlike the past, the modern trend is not establishing local monopolies, but taking the best of both the private and public sectors and producing the best quality of services for the lowest cost to the taxpayer.

Finally, privatization is not a danger to line workers or union members. There is a pernicious canard that the cost benefits of privatization come at the expense of the salaries, benefits, and jobs of employees. This is rarely the case. For the most part, savings come from inefficiencies, poor procurement practices and excessive administrative overhead. Privatization need not be a threat to union workers. Even in cases where companies provide employees, they are often unionized—and many times public employees are shifted to the private payroll. Unions can also gain from privatization. In some cases, unions have successfully bid to be the service provider as in Indianapolis. Expansion of service, also has increased union membership.

Research into the effects of privatization on public employees has exploded the myth. A 1989 U.S. Department of Labor study reported that only seven percent of the 2,313 employees impacted by privatization over a five-year period were laid off.<sup>1</sup> Others were absorbed into the workforce, hired by the private firm, or retired. The study also found comparable wages and benefits for public employees, although pension benefits for private sector firms were slightly lower. However, private sector firms can offer 401(K) plans, better training, and more opportunity for advancement. Similar findings were discovered in a survey of 516 municipalities in Illinois.<sup>2</sup> Overall, there is little compelling evidence to suggest that employees are worse off as a result of privatization.

### Historical Perspective

**Recent history.** Governments in the United States have also long contracted with the private sector for service provision. An early American example of privatization is the Pony Express, where private contractors were hired to deliver mail in the Old West.

Privatization increased in popularity during the late 1970s and 1980s during an era of skepticism towards government's ability to solve problems.

Presidents Carter and Reagan both ran as outsiders trying to tame an out-of-control federal bureaucracy. The belief that the private sector could provide services better, faster and cheaper became prevalent during the heady days of the Reagan revolution. In addition, a variety of tax limitation measures were passed in state and local governments across the nation. Proposition 13 in California, which limited the growth of property taxes, was passed in 1978 and led to similar legislative efforts in other jurisdictions. Most states adopted laws designed to limit revenue and expenditure growth. This wave manifested itself in Illinois with passage of property tax caps in nearly one-third of the counties during the mid-1990s.

For local governments, additional pressures to privatize services arose from unfunded government mandates especially for environmental services. Increasingly stringent regulations on drinking water and wastewater were imposed on local governments without funding to help cover costs. During this period of unfunded mandates, the federal government reduced many grant programs that localities depended on to fund various programs. The double whammy of unfunded mandates and reduced levels of intergovernmental assistance combined to force local officials to consider arrangements with private firms to upgrade aging infrastructure systems. In addition to these trends were normal financial challenges facing governments such as growing demands for services and rising personnel and equipment costs. The federal government began turning more services over to the state and local levels during the 1990s as part of a devolution of services to increase accountability and improve service delivery. Some states, in turn, shifted responsibility for programs and services to local governments. For example, welfare reform involved states taking over responsibility for job training and placement services for welfare recipients. A few states have turned the functions over to local governments.

During the 1980s, privatization emphasized cost reduction and threatened public employees and managers. Although many governments continued to pursue contracting, the term privatization evoked fear, resentment and intense opposition. Studies of privatization in the 1980s show that the

major opposition to privatization initiatives came from employees, especially unionized workers.<sup>3</sup>

In response to these findings, proponents of privatization devised strategies to soften the impact on public employees in order to overcome potential opposition. The 1990s brought forth state and local government leaders who believed not necessarily in the sanctity of privatization, but in competition for services to bring out more efficiency and quality services. Some of the more innovative leaders have developed forms of managed competition where public employees and managers compete for contracts with private sector firms. Thus, privatization in the form of managed competition has become a more progressive term involving outsourcing and careful strategies designed to assist employees displaced by the process. In fact, government leaders from both parties adopted privatization as a way to increase and enhance service delivery and reduce the size and cost of government. Democrats, such as Mayors Ed Rendell of Philadelphia and Richard Daley of Chicago, and Republicans Steve Goldsmith of Indianapolis and Governor William Weld of Massachusetts, led a dramatic shift in how government operates as we approach the 21st century.

**Global trends.** The worldwide growth in privatization began in the mid-1970s, several years earlier than in the United States. Global trends have involved more sales of assets than management of contracts. This is because many countries in the 1970s still retained ownership of assets such as telephone, oil, gas and electrical companies. Many East-bloc, Communist states owned all sources of production, meaning there were ample opportunities for divestiture. Under General Pinochet, Chile began the world's first widespread privatization efforts in 1974. The government sold mainly minority stakes in banks and industrial groups. Later, Chile became noted for successfully developing a privatized pension system that attracted widespread interest among officials in the U.S. considering a similar system.



Western industrialized countries also began shedding many state-owned enterprises. Margaret Thatcher was elected in Great Britain on a platform promising massive privatization of state-owned industries. In 1981, British Aerospace became the first company to be partially privatized in Britain. Thatcher went on to successfully privatize many inefficient government enterprises, including British Telecommunications, British Gas, Rolls Royce, British Steel, and the nation's water and electric utilities. The aggressive privatization program begun under Margaret Thatcher was a major factor in Britain's economic resurgence during the 1980s. As of 1995, 48 major businesses had been sold, bringing the British government \$95 billion in revenues.

Underperforming, overstaffed public companies that cost taxpayers 50 million pounds a week in 1981 now provide 55 million pounds a week in taxes and dividends to the British Treasury. Productivity, profits and stock prices increased as a result of Thatcher's privatization efforts.

The transformation from public to private in Britain is so successful that the Labor Party in 1995 eliminated its 77-year-old platform espousing nationalized industry government and instead called for a "thriving private sector."<sup>4</sup> Even the British Socialist Party softened its long-term opposition to privatization. Other Western countries followed Britain's example. Japan, France and Germany later followed with asset sales of telephone companies, banks, and industrial firms.

The fall of the Berlin Wall in 1989 led to widespread privatization of state-owned firms throughout eastern Europe. Countries such as Poland, the Czech Republic, and Hungary sold off billions of dollars worth of enterprises to private investors. Even Russia under Boris Yeltsin became involved with privatization in 1992 by distributing vouchers for an auction of trucks.

The extent and dollar amount of privatization has increased over the years since the 1970s. According to the International Privatization Update, approximately 2,700 state-owned enterprises were privatized in more than 95 countries from 1988 to 1995, raising \$271 billion in revenues. By region,

Western Europe had the largest share of privatization volume in 1994, with 47.5 percent, followed by Asia/Pacific, 18.0 percent; Eastern Europe, 16.5 percent; and, Latin America, 14.3 percent. In 1997, there was a record-setting \$160 billion of total value of privatizations worldwide, shattering the previous mark of \$89 billion in 1996. The figures were boosted by an unusually large number of very large sales, especially of state-owned energy and telecommunications firms in Western Europe. Recently, another milestone was reached with the largest privatization in Latin American history, a restructuring, valuation, and sale of a telecommunications firm in Brazil for \$19 billion. Privatization of assets in the past 20 years has easily been one of the largest transfers of property in history.

Overall, privatization has successfully increased the efficiency of affected companies according to the World Bank's International Finance Corporation. More than two-thirds (67 percent) of the companies the World Bank affiliate helped privatize report "good" profitability, an increase from 29 percent who reported "good" profits when they were still publicly owned.<sup>5</sup>

However, not all instances of privatization have worked as backers intended. The lack of property laws in Russia has hindered widespread privatization. Mexican officials have had difficulty privatizing the state-owned oil company due to political concerns over turning a key domestic industry to foreign investors. Even Western nations have experienced difficulties with sale of assets. Privatization of water companies in Britain resulted in higher prices, lower efficiency and reduced levels of competition. Japan also experienced difficulties because it continued to privatized firms with excessive regulation.

There remain many opportunities for sales of assets worldwide as countries continue to shed assets and raise funds for public services. East-bloc and Third World nations especially have many more opportunities for privatization. Leaders will be carefully watching the outcome of previous transactions before moving too quickly to sell remaining assets. It seems likely, however, that the trend begun by a South American general will continue into the foreseeable future.

**How To Make Privatization Work**  
**Success factors.** As more governments have privatized services during the past 20 years, officials are learning lessons from previous efforts and tailoring successful strategies to their local circumstances. There is no formula for a successful privatization initiative. Situations will vary according to the local political, economic and labor environments. Accumulated research indicates the following strategies are usually identified with a successful privatization:

*\* Pick the right services*—While nearly every service imaginable is contracted for somewhere in the U.S., officials should exercise caution in choosing which services to privatize. Many officials consider services which are already heavily provided in the private sector where expertise and experience can help create efficiency and cost savings in public operations. For example, most local governments have contracted solid waste collection services where local, regional and national firms compete. Other services likely to be considered for privatization include ambulance, street maintenance and repair, information technology, janitorial, and legal services. Many governments also contract for seasonal or specialized services where full-time employees are not needed. Examples in this category include tree trimming, automobile towing, and snow plowing.

*\* Instill competition in the process*—Many officials are finding competition, not simply privatization, as the key to creating efficiency in government. The issue has become more competition versus monopoly rather than public versus private. Competition for services can create efficiency, innovation and cost savings in the provision of services. Simply turning a public service over to a private monopoly could result in higher costs and poorer service. Innovative leaders in cities such as Indianapolis and Phoenix have devised managed competition systems where public employees can compete for contracts. In fact, Mayor Stephen Goldsmith of Indianapolis has developed a Yellow Pages test, where the city will open services to competition if he finds five or more private firms providing a service in the phone book. Indianapolis' model of managed competition has been the most successful in the nation, with savings of more than \$100 million, public sector



employment down 30 percent, and savings converted to infrastructure improvements and increased police patrols.

**\* Accurate cost data**—It is imperative for governmental bodies to develop reliable and complete cost data to correctly analyze public versus private costs of services. Many government officials incorrectly assume a line item figure represents the cost of providing a service. However, the line item number fails to take into account indirect and overhead costs. Full-cost accounting of government services helps to level the playing field between public and private competitors. While it is difficult for most governments to gather the necessary information for full-cost accounting, the city of Indianapolis and state of Virginia have developed systems to obtain more precise and complete cost data.

**\* Contract monitoring**—Public officials should not expect their role to end when a contract is signed with a private firm. While government's role is reduced through privatization, the need for an enhanced monitoring and oversight system is increased. An effective contract monitoring system will evaluate compliance with the terms of the agreement and measure and evaluate performance to ensure the public interest is protected. It is vital to spell out the roles and responsibilities of the parties to the agreement, including assurances that the contractor will properly deliver the service and handle complaints from the public. Lack of effective contract monitoring is the leading cause for failure of privatization agreements. In fact, a recent GAO report stated that monitoring contractor's performance is the weakest link in the privatization process.

**\* Employee transition strategies**—As mentioned previously, the greatest source of opposition to a privatization initiative is likely to be from employees. Public officials need to develop strategies to smooth the transition to private sector employment. Some common ways to lessen the impact of privatization on public employees are finding other government jobs for displaced employees; requiring the contractors to hire affected employees; or, reducing the workforce through attrition. Chicago, for example, requires that employees affected by privatization receive first interview rights with the private contractor. Many govern-

ments are attempting to ensure that employees do not lose their jobs due to privatization even though it reduces some cost savings. It is more important to forego savings at the beginning of a contract than face a torrent of opposition up front because of potential layoffs.

As governments continue to adapt success factors to local conditions, innovative strategies will be developed such as managed competition and public employees bidding on contracts. Creative public officials in both the public and private sectors are finding ways to overcome obstacles to privatization.

**Summary.** Increased use of privatization is part of a worldwide trend unleashing market forces on the provision of government services.

Competition and choice, prices and profits are the buzzwords of innovative officials who are changing the face of both the public and private sectors. While privatization is not a new concept, its use is growing due to public backlash against the size, effectiveness and cost of government.

The increasing cost of government has lead to privatization or competitive contracting being analyzed for virtually every service and at every level of government activity. Every service is being tested against a very basic question: Can government provide a better service at lower cost by opening up the process to competition? The overwhelming evidence indicates that the answer is Yes.

1 U.S. Department of Labor, "The Long-Term Implications of Privatization," National Commission on Employment Policy (NCEP), Washington, D.C., 1989.

2 Johnson, Robin A., and Norman Walzer, "Competition for City Services: Has The Time Arrived?" Office of the Comptroller, Springfield, Illinois, December 1996.

3 Mercer Group, "1990 Privatization Survey," The Mercer Group, Atlanta, Georgia, 1990. International City and County Management Association (ICMA), "Municipal Year Book: 1989," ICMA, Washington, D.C., 1989. Touche, Ross and Company, "Privatization in America," Touche, Ross and Company, Washington, D.C. 1987.

4 Milbank, Dana, "Backlash," Wall Street Journal, October 2, 1995, p. R17.

5 Allen, Michael, "What is Privatization Anyway?" Wall Street Journal, October 2, 1995, p. R4.



## Cost Savings, cont'd

determining contract administration costs. The Texas state auditor modified this formula for that state's use, and the State of Virginia relied heavily on the federal government's A-76 framework as the basis for cost analysis in its privatization program. The Department of Defense projects it can save about \$6 billion by 2003 and \$2.5 billion in each subsequent year by applying A-76 to more of its programs and activities. In a June 1998 review GAO concluded that A-76 can be "an effective management tool in increasing the efficiency of the federal government and saving scarce funds."

- **Activity-Based Costing.** Designed to identify the costs of providing government services, activity-based costing (ABC) is the assignment of costs to activities based on the consumption of resources by those activities. It is a process or sequence of events which converts inputs or resources to outputs. By analyzing the relationship between costs and performance, ABC seeks to answer questions like, "How much does it cost to process a voucher or invoice, complete an inspection, approve a license, clean a mile of road, resolve a taxpayer grievance, treat a gallon of waste-

water, conduct a health screening, or produce an article such as this one?" The City of Indianapolis has been recognized nationally for its use of activity-based costing. The State of Virginia is now piloting ABC as a possible replacement for the A-76 process it previously adopted.

Experienced governments have reported that detailed cost analyses are more time-consuming and costly, but the payoff comes in their ability to better evaluate competing proposals and identify cost savings. There is probably a need for methods or tools to make cost analysis a bit less daunting, and there are certainly resources available to help governments interested in doing these analyses. (See box below)

### In Conclusion...

In the absence of good cost information, we have to admit that we simply do not know the real costs of government services. We don't know what the cost drivers are. We are unable to explain how costs and performance relate. We have no rational basis for reducing costs. We are unable to compare various service providers for competitive purposes. Perhaps most importantly, however, without solid cost and performance information, we cannot demonstrate that taxpayers are getting a good 'bang for their bucks.' And the inability to generate this kind of information, raises other serious issues and questions: How do government executives manage their programs and services? What do elected officials use as the basis for policy decisions? Is there any real accountability to those who pay for programs and services? For as Hugh Collum, the Finance Director of SmithKline Beecham has observed, "If you aren't keeping the score, you're only practicing." ■

#### Selected Resources for Cost Analysis

*"Activity-Based Costing and Management: Issues & Practices in Local Government," GFOA Research Center, 1997.*

*"A Guide to Best Practices for Performance-Based Service Contracting," Office of Federal Procurement Policy, Office of Management and Budget, April 1996.*

*"Circular No. A-76 (Revised), Performance of Commercial Activities," Executive Office of the President, Office of Management and Budget, August 1983.*

*"Competitive Cost Review Cost Analysis Guide," State of Texas, Office of the State Auditor, 1987.*

*"Competitive Government Handbook," State of Arizona, Governor's Office of Management and Budget, 1996.*

*"Cost Comparison Program: Compete," State of Virginia, Commonwealth Competition Council, 1996.*

*"How to Compare Costs Between In-House and Contracted Services," Reason Foundation, March 1993.*

*"Performance-Based Contracting," Reason Public Policy Institute, May 1997.*

## State Procurement, cont'd

previously did not accept State of California business would, because of the quick payment, accept the Cal-Card.

A procurement card also streamlines the procurement and reimbursement process by eliminating the majority of the paperwork associated with a purchase including the purchase order, invoice and payment voucher. By reducing the amount of paperwork necessary to initiate and complete a transaction the procurement card also saves money and employee time. When the State of Florida announced a procurement card program State officials cited studies showing that a procurement card program could save the State \$121 per transaction in reduced processing costs.

The issues of control and accountability are always a concern when a procurement card is implemented. In addition to the transaction limits discussed above each procurement card has restrictions on where it can be used (based on the vendor's Merchant Category or Standard Industrial Classification Code). These controls are enforced when a purchase is made and can be established at a company level or a cardholder level. Daily or weekly transaction reports are available from the issuing bank for the purpose of timely review of charges. Additionally, cardholders typically have to enter their purchases in an online system that is then reviewed by the department's designated "reconciler" and the Purchasing Department before payment is made to the card issuer.

### Privatizing Office Supplies

Despite the inflexibility and lack of efficiency in some aspects of the procurement process for much of Illinois State Government, there have been improvements made in some areas. The most notable is the transformation of the State-Operated Office Supplies stores to "Stockless Office Supplies" which occurred in the fall of 1995.

In fiscal year 1995, it was decided that the state should be able to get better access to more supplies at a lower cost without the overhead associated with the Office Supply Stores. The decision was made to privatize this procurement function.

CMS issued a Request for Proposal to vendors which were publicly opened

*See STATE PROCUREMENT, back page*



## Privatization - A Winning Alternative for Taxpayers

"The biggest challenge facing elected officials today is giving taxpayers value for their tax dollars," says Bobby Hogue, the Democratic Speaker of the House of Representatives in President Clinton's native state of Arkansas. With tax burdens at an all-time high in peacetime, voters are demanding some form of accountability for the money they turn over to the tax collector. That often involves efforts to privatize or introduce competition in the provision of government services.

The simple fact is that most people no longer believe that government services are a good buy. Just compare the explosive growth of fax machines, e-mail, Federal Express and other means of delivering data swiftly and cheaply with the declining market share of the U.S. Postal Service. Or contrast the level of service you get from any private credit-card company with that of your local motor vehicle bureau.

The biggest difference between private or competitive provision of government services and traditional bureaucratic delivery methods is simple: consumers have some recourse when service is shoddy. Indeed, does anyone doubt that if certain inner-city public schools were a consumer product on a supermarket store shelf they would be removed for being defective and sued for false advertising?

Privatization allows elected officials to improve the quality of government services and often save taxpayer dollars at the same time. In addition, private provision of services allows for more flexibility, speed and innovation. That's why the Council of State Governments reports that 55% of their members believe privatization efforts in their states will increase in the next five years and only 7% think they will decrease.

The most significant development in privatization in recent years is that it has largely ceased to be a strictly ideological issue, with conservatives favoring it and liberals opposing it.

"Privatization and contracting out services is often a management issue and

doesn't have to be political," says David Osborne, an adviser to President Clinton and author of "Reinventing Government". He notes that in cities such as Indianapolis and Phoenix, municipal unions became enthusiastic partners in contracting out services such as garbage collection after they were given chances to bid on the contracts. In both cases, unions were able to use their familiarity with service delivery to change work rules and incentive structures to win the low-bid contracts. "The status quo in government services can't remain forever, and if changes are inevitable, it's important that we adapt and make sure we're part of any reform," one Indianapolis municipal union official told me.

Neighboring Illinois is now in the forefront of this rethinking of how to provide more services at a lower or equal cost. The Center for Competitive Government reports that state and local government in Illinois contracts out 85% of solid waste disposal to private contractors. The same is true of over three-quarters of recycling efforts and over half of day care provision. Some communities have gone further. Hoffman Estates, a suburb of 50,000 people near Chicago, uses contracts with over 50 private vendors to provide over 100 individual government services from paving roads to pest control. The annual savings are over \$250,000 in payroll costs alone. In addition, the city did not have to lay off any municipal workers. Reductions were accomplished solely through attrition.

Of course, privatization is not without risks. Careful monitoring of private contracts to avoid fraud and abuse is essential. No one should underestimate the continued political obstacles to privatization either. But as public demand for services and a better use of taxpayer dollars continue to grow together, privatization will continue to become one of the most effective ways to achieve both goals.

*John H. Fund is an editorial board member of The Wall Street Journal.*



## State Procurement, cont'd

on August 1, 1995. As a result of this process, two master contracts were established for "Stockless Office Supplies". The contracts were awarded to Boise Cascade Office Products for the Chicago Metro Area and to American Loose Leaf for the Springfield Capitol Complex area.

In addition to access to more supplies at a lower cost and the elimination of overhead costs of the State-Operated Supply Stores, free next day delivery was ensured regardless of the order quantity. Both vendors guaranteed substantial discounts (American Loose Leaf 55% - Boise Cascade 52%) from their catalog prices. In addition, office supplies that remained in the Office Supply Stores when they closed were purchased by American Loose Leaf and Boise Cascade.

The decision to privatize the office supply procurement and distribution function at CMS truly represented increased efficiency and cost effectiveness within the system. It is this type of thinking that has led, and hopefully, will continue to lead to the greatest utilization of taxpayer dollars. ■

## Infrastructure, cont'd

method of innovative financing for water, wastewater, mass transit and other public projects. Thus, privatization offers local governments the opportunity not only to increase efficiency in operations, but also to strengthen economic development and job creation efforts.

1 Bleakley, Fred R., "Infrastructure Dollars Pay Big Dividends", *Wall Street Journal*, August 12, 1997, p. A2.

2 Ibid.

3 Eisenhardt, Paul, Andrew Stocking and William Reinhardt, "Gradual Growth and 17 Long-Term Deals Mark 1997 Water and Wastewater Contract Operations", *Public Works Financing*, March 1998, Volume 116, p. 5.

4 Beecher, Janice A., G. Richard Dreese and John D.

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5 Johnson, Robin A. and Norman Walzer, *Competition for City Services: Has the Time Arrived?*, 1995, Springfield, IL: Office of the Comptroller, p. 9.

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7 Beecher, Dreese and Stanford, p. 38.

8 Peterson, W.A., "Privatization at a Crossroads", *Water Environment and Technology*, November 1994, p. 56.

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10 Wessel, David, "The American Way?", *Wall Street Journal*, October 2, 1995, p. R8.

11 Holusha, John, p. 14.

12 Calculated from the National Transit Database and American Public Transit Association (APTA) data.

13 Wendell Cox & Jean Love, "Rescuing Transit in Chicago: Redirecting CTA to Serve Customers First," (Metropolitan Transportation Association, March, 1998).

14 Anthony M. Pagano, "An Analysis of Proposed CTA Service Cuts: New Public Sector Management Alternatives," (Metropolitan Transportation Association, May, 1997).

15 Management/Administration Study for the Regional Transit District (Denver), (Mundle & Associates and Wendell Cox Consultancy), 1996.

16 Calculated from historical data in Metropolitan San Diego Short Range Transit Plan (Metropolitan Transit Development Commission).

17 Calculated from National Transit Database 1992-1994, and ATC-Vancom 1995 National Transit Database report (operations and maintenance costs.)

18 Calculated from data in London Transport Annual Reports.

19 Information provided by Copenhagen Transport (HT).

20 Wendell Cox & Jean Love, "Rescuing Transit in Chicago: Redirecting CTA to Serve Customers First," (Metropolitan Transportation Association, March, 1998).

21 Ibid.



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### Fiscal Focus

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